

# Macro Comment

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## Straight talk about the debt and the deficit

*During the next few weeks, the President will submit his budget proposals for the fiscal year starting in October 2011. This will kick off a debate over government spending, taxation and the debt ceiling that could lead to a shutdown in the government in early March. Unfortunately, both parties are likely to claim that their approach will reduce the deficit, but neither party is likely to admit that the debt will continue to pile up in the years ahead.*

The Congressional Budget Office, the non-partisan branch of Congress responsible for evaluating the costs of government programs, recently announced that the U.S. budget deficit will probably increase to \$1.5 trillion dollars in the fiscal year ending in September 2011. That would be up from \$1.3 trillion in the fiscal year ended in September 2010. The deficit will be higher because Congress extended the Bush era tax rates at the same time it cut payroll taxes two percentage points and extended unemployment benefits again. The economy is likely to benefit from the lower taxes in the short run, but the government will have to borrow the \$1.5 trillion, causing the total amount of federal debt to increase by this amount. Consequently, the total federal debt outstanding could increase to more than \$15 trillion by the end of this September from \$13.56 trillion at the end of September 2010.

During the upcoming budget and debt ceiling debate, both parties are likely to propose plans that would reduce the deficit in coming years. They will throw out big numbers, and it will sound like they are making progress on reducing the debt. However, as long as there is a deficit, the debt will continue to pile up. When a government official says that their program will reduce the deficit by \$400 billion over the next 10 years, it sounds like they are reducing the debt. But a smaller deficit will not cause the debt to go down. The debt will just increase \$400 billion less over 10 years. To reduce the debt, the government needs to run a surplus and pay off old debt with the surplus. That is unlikely to happen anytime soon.

So let's put this into perspective. If Congress does nothing and continues to run a \$1.5 trillion dollar yearly deficit, the debt of the United States would increase by \$15 trillion over ten years, pushing the total federal debt outstanding up to more than \$30

trillion. If the government adopts a plan that reduces the deficit by \$400 billion over ten years, the debt will only increase by \$14.6 trillion not \$15 trillion over ten years. In other words, the total debt outstanding would increase to \$29.6 trillion not \$30 trillion. It would be nice if politicians would talk straight and admit that the debt will continue to increase substantially even if they pass a new program that reduces the deficit by \$400 billion over 10 years.

In order to stop the debt from rising, Congress would need to stop running deficits. To stop running deficits, Congress would need to cut spending and/or increase taxes by \$1.5 trillion per year or by \$15 trillion over 10 years. This is unlikely to happen.

This analysis assumes that the federal deficit would stay at \$1.5 trillion per year if Congress does nothing. Fortunately, as the economy recovers from the recession, tax revenues are likely to increase, and the deficit is likely to come down a little if nothing else changes. However, the deficit could still stay high if Congress spends that extra revenue on other programs.

As consumers we know that to reduce our credit card balances, we need to stop using the credit cards and/or pay more on the cards than we charge each month. The government needs to do the same thing. It needs to spend less than it receives in revenue and use the surplus to pay off the outstanding debt. If you listen to the upcoming budget and debt ceiling debate, you are unlikely to hear anyone say this.

It is no wonder that many investors are concerned that the United States may be headed for serious debt problems like some European countries. This does not have to happen. The budget deficit can be

reduced, and the pile of debt that we leave to future taxpayers does not have to increase dramatically. However, both parties need to stop suggesting that reducing the deficit is the same as

reducing the debt. Any deficit adds to the debt pile. A smaller deficit just makes the debt pile grow more slowly than a large deficit would.

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