

ECONOMICS: US PERSPECTIVES—FEBRUARY 19, 2010

Can the US Ensure Fiscal Sustainability as Deficit Swells and Debt Burden Rises?

■ **Joseph G. Carson**

US Economist and Director—Global Economic Research

The new commission on fiscal responsibility faces a huge task to tackle a rising debt burden. In our view, a credible strategy for restoring US fiscal balance must not rely heavily on tax increases, but should aim to reduce a record expenditure ratio by securing bipartisan support for budget cuts.

Fiscal alarm bells are ringing in Washington. With the US federal deficit expected to reach 9.2% of GDP during 2010—almost triple the deficit of 2008—President Obama this week established the National Commission on Fiscal Responsibility. The mandate of the 18-member committee is to draw up recommendations that will help lawmakers draft legislation aimed at bringing the federal budget deficit down over the next decade.

Headed by Bill Clinton’s former White House Chief of Staff Erskine Bowles and former Wyoming Republican Senator Alan Simpson, the new commission is not the first forum created to deal with national fiscal issues. In 1981, former Federal Reserve Chairman Alan Greenspan led a commission established to address the short-term financing crisis of the Social Security trust fund. Two years later, its report became the basis for legislation to resolve the problem and prompted other changes to Social Security law.

But the enormity of the new commission’s task looks much more daunting because the future financing issues are larger and more complex than those of 30 years ago. Moreover, there is no bipartisan support for the formation of the commission, let alone any indication that Congress will actively pursue its recommendations.

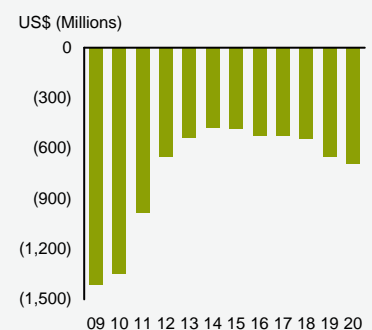
Increased Focus on Sovereign Risk

Since the creation of the new commission coincides with an increased focus on sovereign risk, we think it’s a good time to examine current and future US budgetary trends in order to assess the scale of the task at hand. Could the US suffer a crisis of fiscal sustainability like those which some European countries have recently faced?

According to the Congressional Budget Office (CBO), the federal deficit for the current fiscal year is estimated at \$1.35 trillion, down slightly from a record deficit of \$1.41 trillion in 2009 (**Display 1**). These projections would put the deficit in fiscal 2010 at 9.2% of GDP (**Display 2**), compared

Display 1
Large Deficit Expected to Persist...

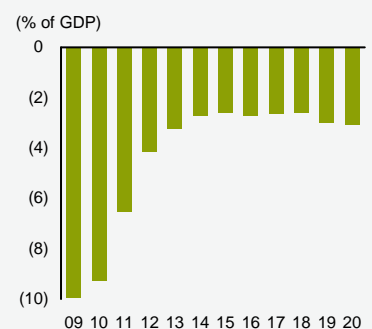
Long-Term Federal Budget Projections by CBO



Source: Congressional Budget Office and Haver Analytics

Display 2
...but Deficit Will Fall to Manageable Levels Relative to GDP

Projected Federal Deficit as % of GDP



Source: Haver Analytics, Congressional Budget Office and Office of Management and Budget

with 1.2% of GDP in 2007 before the recession. Under this scenario, the marketable debt-to-GDP ratio, a key barometer of fiscal sustainability, will climb to an estimated 60.3% this year, from 53% in 2009.

Deficit Projected to Fall

Based on current tax and spending policies, and assuming a moderate economic recovery, the CBO estimates that the federal deficit will fall to \$480 billion or 2.6% of GDP by 2015. Such a huge drop, especially relative to GDP, would be welcomed by financial markets. It would also place the US fiscal deficit well below the level projected by governments such as Greece that are currently under pressure to shrink their bloated deficits.

However, even if the federal deficit follows the CBO's declining projections, the large dollar deficits will continue to increase the federal debt burden. Indeed, according to estimates by the CBO, the marketable debt-to-GDP ratio would rise to 65% by 2015 and further increase to 66.7% by 2020 (**Display 3**). This would still be well below the threshold of 90%, a level which begins to undermine a country's growth rate, according to some studies. Nevertheless, an increasing debt ratio is a worrying development in our view, and the new commission should seek to halt and ultimately reverse the trend.

Servicing the outstanding debt creates another challenge for fiscal sustainability. Gross interest payments on US debt will total \$383 billion or about 18% of overall receipts in 2010, according to the CBO (**Display 4**). Even though a recovery in economic growth will trigger a substantial increase in federal receipts over the next five years, the ratio of interest payments to receipts will also rise to 20% by fiscal 2015 and is projected to stay at elevated levels through 2020. This relatively inflated share of interest payments to receipts adds an obligatory expense to all mandatory government expenditures (i.e. social programs) making it even harder in the long run to reduce the deficit and restore budget balance.

To complicate matters further, history shows that revenue increases can only go so far in helping to close the budget gap. For example, the CBO estimates that federal receipts, which amount to 14.9% of GDP in fiscal 2010, will climb to 19.7% in 2015 and 20.2% in 2020 (**Display 5**). If achieved, the ratio of federal receipts to GDP in 2020 would match the record high for any single year.

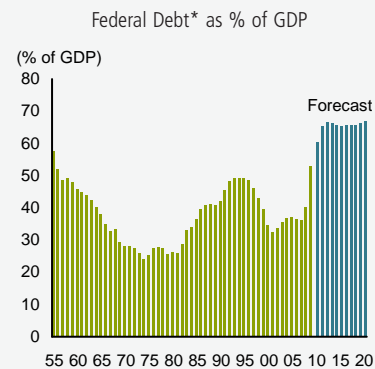
These figures suggest that several decades of US tax legislation initiatives have hardly affected the level of federal tax collection. Marginal tax rates have been raised and lowered, the number of tax deductions has been reduced and changed, but federal receipts as a percentage of GDP have not changed dramatically and should not be relied upon by the new commission and policymakers to alleviate fiscal stress. In fact, the GDP growth rate has played a much bigger role than any tax changes in lifting government tax revenue.

Low Expenditure Ratio Is Key

In our view, the commission must keep this important fact in mind as it attempts to design recommendations to restore budget balance and ensure long-term fiscal sustainability. We believe that a credible strategy for restoring fiscal balance should not rely heavily on increased revenue induced by tax legislation, and the US must lower its ratio of expenditure to GDP, which reached 24.7% in 2009.

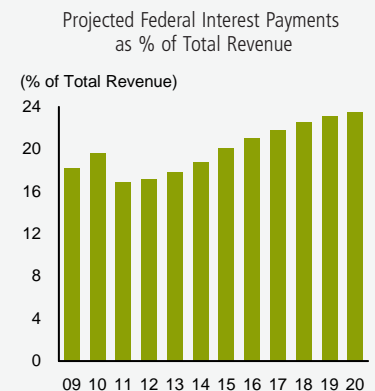
Despite racking up record deficits in recent years and the persistence of large absolute deficits in the intermediate term, US fiscal finances are in much better condition than some weaker European countries, which are under pressure from financial markets to lower deficits and restore their fiscal credibility. That said, the US will still face difficult fiscal choices soon because today's deficits are particularly hard to reduce due to the rising interest expense ratio. As the new commission forms its agenda, we believe it must present a wide range of policy options that will gain bipartisan support to secure a steady and substantial decline in the federal deficit and to ensure that the

Display 3
Big Sustained Deficit Raises Debt Burden



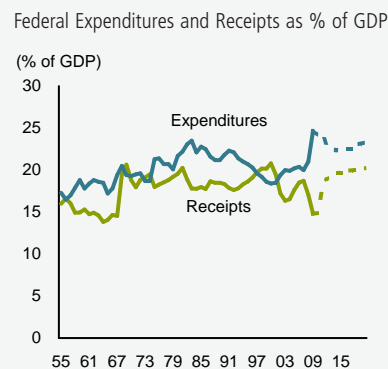
*Marketable debt (held by public sector).
Source: Congressional Budget Office and Haver Analytics

Display 4
Rising Interest Payments Pose Challenge



Source: Congressional Budget Office and Haver Analytics

Display 5
Lower Expenditure Ratio Needed to Balance Budget



Source: Haver Analytics, Office of Management and Budget and US Treasury

US avoids a fiscal crisis as it recovers from recession and restores economic growth.

This document reflects the views of AllianceBernstein and sources believed by AllianceBernstein L.P. to be reliable as of the dates cited. No representation or warranty is made concerning the accuracy of cited data. Nor is there any guarantee that any projection, forecast or opinion will be realized. The views expressed may change at any time. References to stocks, securities or investments should not be considered recommendations to buy or sell. The value of investments, and the income from them, can fall as well as rise and you may not get back the original amount invested. Past performance is not a guide to future performance. The value of overseas securities will be subject to exchange-rate fluctuations. Under no circumstances should this information be construed as investment advice. Nor should it be construed as sales or marketing material for any financial instrument, product or service sponsored or provided by AllianceBernstein or its affiliates or agents.

Note to Canadian Readers:

AllianceBernstein provides its investment management services in Canada through its affiliates, Sanford C. Bernstein & Co., LLC, and AllianceBernstein Canada, Inc.

Note to UK Readers:

UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

Note to Taiwan Readers:

This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited, SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity and an independently operated business.

Note to Singapore Readers:

This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C.) The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Hong Kong Readers:

This contributor is not licensed by the Hong Kong SFC and does not intend to provide investment advice in Hong Kong. For Financial Representatives General Information only and shall not be regarded as provision of investment advice.