

**“American Gothic”: the Federal debt and how the Visigoths may try to break the system if no one fixes it**

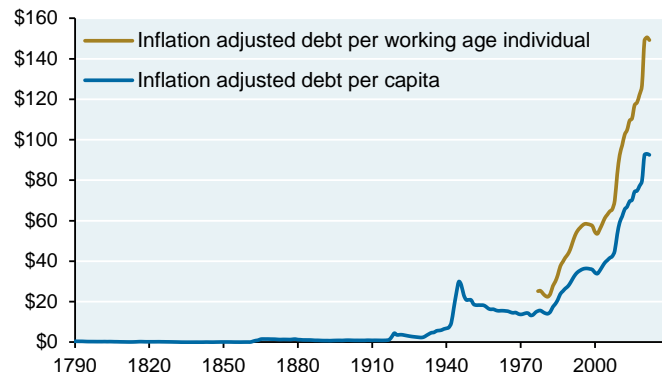
See if you can guess what the people listed below have in common:

- Erskine Bowles, Democratic White House Chief of Staff
- Sen. Alan Simpson, R-WY
- Kevin Warsh, Federal Reserve Board, 2006-2011
- Former OMB/CBO Director Peter Orzag, Obama appointee
- Sen. Michael Bennett, D-CO
- Stan Druckenmiller
- Geoffrey Canada of the Harlem Children’s Zone
- Admiral Mike Mullen, 17th Chairman of Joint Chiefs of Staff
- Former President Bill Clinton
- Michael Pakko, economist at The Federal Reserve Bank of St. Louis
- Richard Kogan of the progressive Center of Budget and Policy Priorities

Answer: at one point or another, all these people either wrote papers<sup>1</sup>, gave speeches or worked on negotiated solutions regarding fiscal deficits, entitlements and “generational theft”, which refers to the Federal debt passed on to future generations. There has been little progress so far. Here’s a look at inflation-adjusted Federal debt per capita since 1790. After the surge in government spending required to defeat the Axis powers during WWII, each American was responsible for \$30k in Federal debt in today’s dollars. Today, that figure is 3x higher, and rising. When we compute the debt burden on the working age population, it looks even worse.

**US inflation adjusted Federal debt per capita**

US\$, thousands



Source: US Treasury, Fed Reserve, Minneapolis Fed, Census. JPMAM. 2022.

<sup>1</sup> One example: “*Deficits, Debt and Looming Disaster: Reform of Entitlement Programs May Be the Only Hope*”, Federal Reserve Bank of St Louis, January 1, 2009

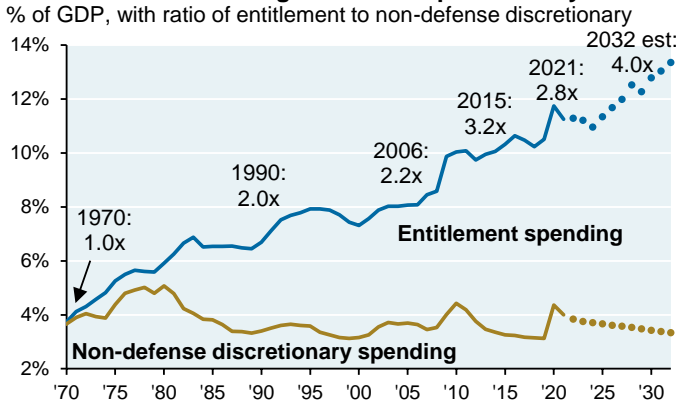


**A related issue: composition of government spending as entitlements crowd out discretionary spending that contributes to productivity and future growth.** Here’s a reminder of what discretionary spending is:

What is non-defense discretionary spending?		
<b>Transportation infrastructure</b>	<b>Science and energy</b>	<b>Law Enforcement</b>
Air, ground and water infrastructure	Renewable energy grid integration	FBI and Border Control
Air traffic control and aviation safety	EPA superfund and arsenic/lead exposure programs	IRS and Federal Courts
Coast Guard and transportation security	Nuclear/clean coal demonstration projects	
High speed intercity rail	Pollution control and abatement	<b>Healthcare</b>
Army Corps of Engineers	Space exploration, National Science Foundation	Vaccine development
		NIH bioterrorism programs
<b>Education and Training</b>		CDC disease control programs
K-12 education, including subsidies for low income and disabled students		Food & Drug Administration
College Pell grants and Head Start pre-school programs		
Job retraining and apprenticeship programs		

Now here’s the chart, on the left. The balance between entitlement spending and non-defense discretionary spending started out at 1.0x when Medicare and Medicaid systems were created in the late 1960’s<sup>2</sup>. That ratio is now almost 3.0x and will rise to 4.0x in a few years. By 2032, entitlement payments plus interest are expected to consume all Federal revenue collection on a permanent basis, with little left for discretionary spending (see Appendix). Some partial solutions to narrow this gap appear in the box<sup>3</sup>; few of them are wildly popular, and it would take a combination of them to reduce the gap back to where it was in the late 1990’s.

**What does the Federal government spend money on?**



Source: CBO, JPMAM, May 2022. Dots are CBO projections.

**Partial solutions to close the gap (charts in Appendix)**

- Senator Sanders plan: large increase in income/capital gains taxes on incomes > \$250k, raising 1% of GDP annually, spent entirely on discretionary spending
- Senator Warren wealth taxes of 1% applied in excess of \$20mm, which would raise 0.5%-0.7% of GDP per year (as per TPC), spent entirely on discretionary spending
- Convert Social Security from a savings program to an entitlement program, then eliminate the cap on income used to compute Social Security taxes without raising benefits; use proceeds to boost discretionary spending
- Means-testing of Medicare B and D, higher Medicare co-pays and deductibles, higher eligibility retirement age, further means-testing of Social Security, increased rebates by Medicare Part D drug manufacturers
- Cut defense spending, close to a 70-year low as a share of GDP at 3.5% but 3<sup>rd</sup> highest in the world per capita

<sup>2</sup> **20th century entitlement politics.** When Medicare was introduced in the 1960s, it was described as “brazen socialism” in the Senate; one album released in 1961 was entitled “Ronald Reagan Speaks Out Against Socialized Medicine”. Two decades earlier, when Truman proposed a national healthcare program, the plan was called a Communist plot by a House sub-committee. And when FDR introduced Social Security in the 1930s, he was branded as a Communist sympathizer by Alf Landon (Roosevelt’s GOP opponent in the 1936 Presidential election), Republican Senators from Ohio, Pennsylvania and Minnesota, and publisher William Randolph Hearst.

<sup>3</sup> **Could a single-payer healthcare system bring down entitlement spending, leaving more room for discretionary spending?** Unclear. Such a system would presumably require that premiums now paid to private sector insurers become taxes to fund healthcare coverage for all citizens. A single-payer system would give the government more leverage to reduce Medicaid and Medicare costs. However, unless *availability* and *access* were curtailed, a single payer system does not guarantee a cheaper healthcare system. As shown in the Appendix, **the cost of entitlement programs has a history of vastly exceeding initial projections.**

**So, now the Visigoths may block the debt ceiling increase unless the White House agrees to spending cuts and a balanced budget within 10 years.** Here are questions I've been getting and my answers to them:

- Would any technical default be followed in short order by political negotiations to put things back on track, such as the Budget Control Act of 2011, the Gramm Rudman Hollings Deficit Control Act of 1985 and the Balanced Budget Reaffirmation Act of 1987? I think so, but have no idea how long it could take to get there
- Will the Visigoths be able to maintain a united partisan front to fight the debt ceiling increase, since only 5 GOP defections would allow it? Not sure. According to CNN, some swing-state Republicans from districts Biden won or narrowly lost, and who are seen as most likely to break ranks with GOP leadership, said they're not willing to back a clean debt ceiling increase and are insisting on a fiscal agreement first
- If the debt ceiling were not raised, could the Treasury decide to pay certain obligations (such as interest on the Federal debt) and not others, which is referred to as "debt prioritization"? Unclear. That would require the Treasury to predict upcoming cash flows accurately and withhold cash in advance. Yellen's public statements have indicated that she considers this beyond the Treasury's ability to execute, although a transcript from a 2013 FOMC meeting includes comments on the Treasury's intention to pay on time<sup>4</sup>
- Are Visigoth concerns about government spending genuine? Who knows and I'm not sure why it matters
- Why don't Visigoths raise the same issues when the GOP controls the White House? Politics
- What might convince Visigoths to reverse course? Stock market correction, debt downgrade (e.g., 2011), opinion polls in the aftermath of a government shutdown and its various consequences
- Is it "responsible" for Visigoths to do such a thing? Not according to our CEO or Janet Yellen<sup>5</sup>
- Why is the debt ceiling showdown occurring a few months before prior expectations? Higher Fed Funds rates increase the amount the Fed pays on reserves, and reduces what it pays to the Treasury. Higher interest on debt may increase the 2023 deficit to \$1.3 trillion, above the \$1.0 trillion deficit projected last May. April's tax receipts will provide a grace period before summer deficits bring the issue to a head sometime between June and August after cash balances and extraordinary measures run out
- Would there be a lasting economic impact from a government shutdown? Probably not; in past government shutdowns, federal workers were retroactively paid for the period when their departments were closed, even when there were no binding commitments in place to do so. Businesses would probably continue to produce and accumulate inventories in expectation of resumed government purchases when the debt ceiling is eventually raised
- What did fixed income investors do last time, in 2011? Some switched from T-bills to longer duration Treasuries or bank deposits. I'm not sure it's worth the aggravation given this bottom line: **a debt ceiling fight is much more likely to lead to temporary forced spending cuts than a long-lasting default on debt**

<sup>4</sup> Three procedures to handle government payments during a debt ceiling impasse: "The first one is that principal and interest payments on Treasury securities would continue to be made on time. The second principle is that the Treasury would decide each day whether to make or delay other government payments. The third principle is that any payments made would settle as usual. In terms of principal and interest payments, principal payments on maturing Treasury securities would be funded by Treasury auctions that roll over the maturing securities into new issues, so the new issues would fund the redemption of the maturing securities. Interest would be paid based on available cash in the Treasury general account. To make a coupon payment, however, the Treasury may need to delay or hold back making other government payments, even if it had sufficient balances on a given day, in order to accumulate sufficient funds to pay a future large coupon payment." FOMC Conference Call Transcript, October 16, 2013

<sup>5</sup> CNBC quoted Jamie as follows: "We should never question the creditworthiness of the US government. That is sacrosanct. It should never happen...Even questioning it is the wrong thing to do. That is just a part of the financial structure of the world. This is not something you should be playing games with at all". Treasury Secretary Yellen said that a US debt default would "cause irreparable harm to the US economy, the livelihoods of all Americans, and global financial stability."



**Bottom line: if reasonable people cannot figure out how to fix debt and spending composition issues in a sustainable way, the Visigoths will try to do it for them, and with more economic disruption and political turmoil.** If the problem goes away somehow this year, and I suspect it will, that doesn't mean that it won't come back again. Not sure I want to be in this role when the true day of reckoning comes.

Michael Cembalest  
JP Morgan Asset Management

See Appendix for exhibits on the interest on the Federal debt, the history of US tax increases, defense spending, actual vs estimated costs of US entitlement programs and the entitlement crossover point



Joseph-Noël Sylvestre, 1890 / Getty Images

### The Sack of Rome in 410 AD

Alaric I was the first king of the Visigoths, after serving in the Roman Army in support of Roman Emperor Theodosius. When Alaric marched on Rome in 410 AD, it was the first time in 800 years that the Eternal City had been attacked. The Visigoths looted and burned the city for 3 days, with the siege lifted only after thousands of pounds of gold, silver, silken tunics, scarlet-dyed hides and pepper were paid to Alaric as tribute, along with throngs of captives.

*“My voice sticks in my throat; and, as I dictate, sobs choke my utterance. The City which had taken the whole world was itself taken”*; Saint Jerome in a letter to Principia

### Debt ceiling glossary of terms

**Debt Prioritization.** Several Republican House members may pursue legislation to force “debt prioritization,” under which the Treasury would only pay some obligations and not others, as spelled out in a specific bill. The Senate is unlikely to pass this, and it might create discord within the GOP based on whose oxes are gored. Secretary Yellen has stated that Treasury does not have the ability to carry out debt prioritization, and believes that it might still be viewed by the rest of the world as a default. However, as indicated in footnote #4, the FOMC in the past has discussed a plan to make interest and principal payments on time during a debt ceiling impasse.

**Spending Cuts with a Debt Limit Vote:** Speaker McCarthy and the House Republican caucus have agreed to tie any debt limit votes to new budget agreements and fiscal reforms. The demands appear to include limiting discretionary spending to FY22 levels, and adoption of a budget that balances within ten years. These are still general demands and not detailed proposals.

**Bipartisan Commission:** Senator Manchin (D-WV) has called for a commission to negotiate spending cuts to pair with a debt ceiling vote. At this time, Democratic Leadership has shown no interest in agreeing to this. In 2011, in exchange for GOP votes on the debt ceiling, a Congressional commission was formed to recommend deficit reduction roughly equal to the size of the increase in the debt limit.

**The Trillion Dollar Coin.** Could Treasury solve the impasse without Congress by pursuing options like such issuance of a \$1 trillion coin to deposit at the Fed, using the funds to all bills due? Secretary Yellen dismissed this approach as a “gimmick.”

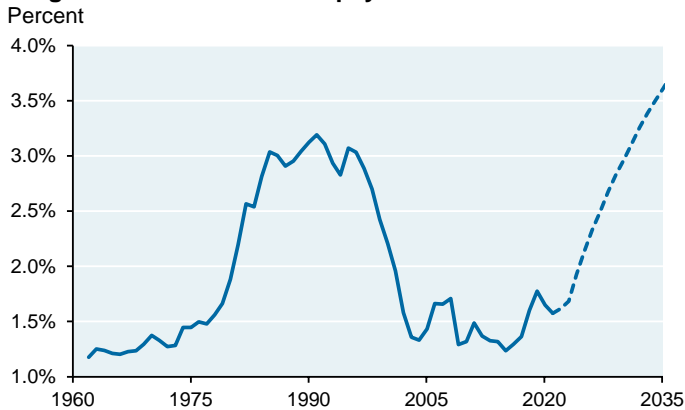
**Special Procedures - House of Representatives Discharge Petition.** If Democrats can find 5 or more GOP members to agree to a clean debt ceiling increase, they can try to force House Speaker McCarthy to bring the debt ceiling bill to the floor by pursuing a “discharge petition”. This would effectively force a vote on any legislative proposal in the House, and generally requires weeks of procedural steps to accomplish.



**Appendix charts**

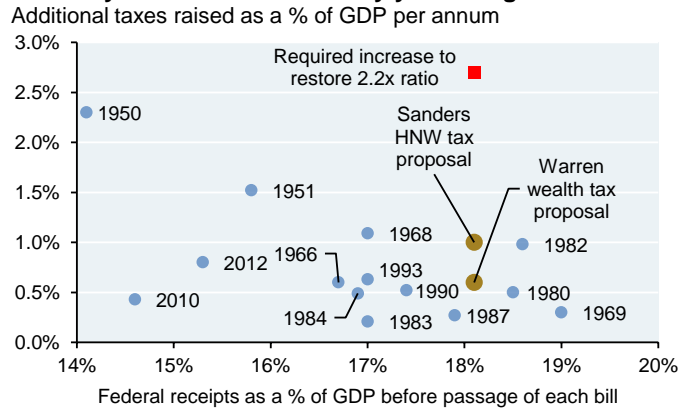
- Interest on the Federal debt since 1960 with CBO projections to 2035
- A history of US tax increases since 1950 (as % of GDP and vs Federal receipts as a % of GDP). While there have been tax increases of 2% of GDP or more, they occurred when overall tax receipts were much lower. The red square shows the required increases in taxes, which if spent entirely on increasing discretionary spending, would reduce the ratio of entitlements to non-defense discretionary spending back to 2.2x. The Sanders high net worth income and capital gains tax plan and the Warren wealth tax plan appear as well
- US defense spending since 1940 as % of GDP, and per capita in 2021 vs other countries
- Actual vs estimated cost of US entitlement programs
- Crossover point: when entitlements + interest are projected to exceed gov't tax revenues

**US government net interest payments as % of GDP**



Source: CBO, JPMAM. 2021. Dotted line indicates estimates.

**A history of US tax increases by year of legislation**



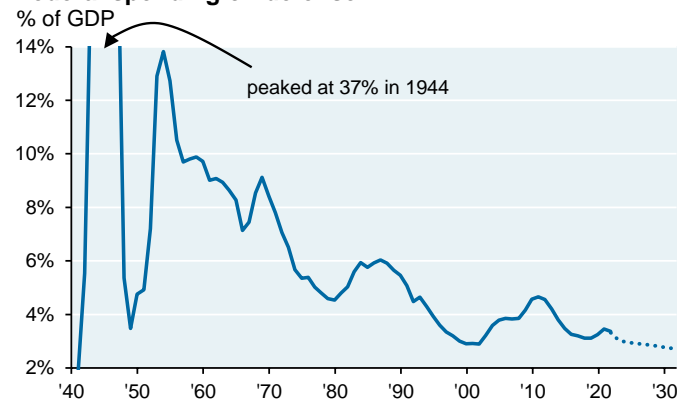
Source: US Treasury, Tax Policy Center, JPMAM. May 2022.

**Initial estimates vs. actual costs of healthcare**

Benefit	Year	Annualized Cost (USD billions)		Actual to estimated cost ratio
		Est.	Actual	
Medicare hospital insurance	1965	9.0	67.0	7.4 to 1
Medicare (entire program)	1967	12.0	110.0	9.2 to 1
Medicare ESRD program	1972	0.1	0.2	2.3 to 1
Medicaid DSH program	1987	1.0	17.0	17 to 1
Medicare home care benefit	1988	4.0	10.0	2.5 to 1
Medicare catastrophic coverage*	1988	5.7	11.8	2.1 to 1
Massachusetts Health Reform	2006	0.7	0.9	1.2 to 1

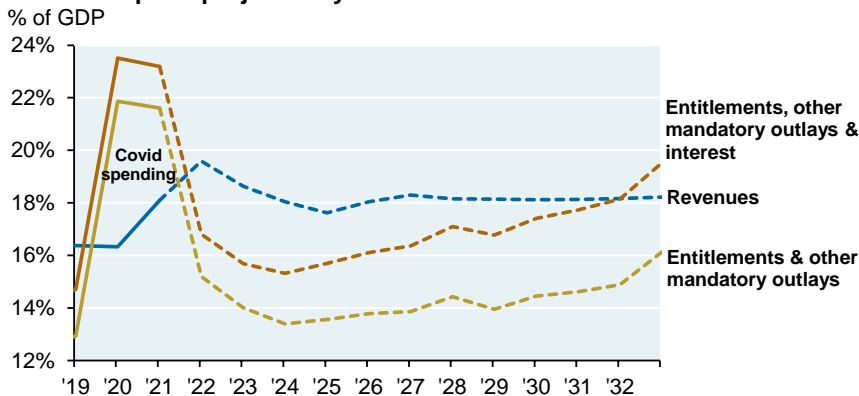
Source: US Congress Joint Economic Committee. July 2009. \* = multi-year estimate

**Federal spending on defense**



Source: CBO, JPMAM. May 2022. Dotted line = CBO projections.

**Crossover point projected by 2032**



Source: CBO, Budget and Econ Outlook, JPMAM. May 2022.

**Defense spending per capita (top 15)**

Country	US\$
Qatar	3,955
Israel	2,769
US	2,405
Kuwait	2,085
Singapore	1,885
Saudi Arabia	1,572
Norway	1,510
Australia	1,231
Oman	1,107
Finland	1,064
Brunei	1,026
United Kingdom	1,002
South Korea	979
Denmark	927
France	866

Source: SIPRI database. 2021.



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