



HARVARD | BUSINESS | SCHOOL

U.S. Competitiveness Project

GOVERNMENT DEBT AND COMPETITIVENESS

Robert S. Kaplan and David M. Walker

INTRODUCTION

The United States federal government's current and projected fiscal deficits are not sustainable. No country, even one as wealthy and resourceful as the United States, can continue to run annual deficits that significantly outpace the growth of the economy (GDP). This issue is well recognized by all sides of the political spectrum and the debates on the deficit, between liberals and conservatives, Democrats and Republicans, focus on how fast to close the gap between current and projected government revenues and expenditures, and what the ideal mix between higher taxes and reduced spending should be.

Less well known, however, is that addressing our nation's shorter-term deficits is in many ways easier, and less important, than coping with the explosive growth in U.S. federal government debt and unfunded obligations. This attention deficit is partly due to terminology. Some people confuse the deficit, which is an income statement calculation, with the debt, which is a balance sheet account. The two are related concepts, since the reported government debt is the sum total of all the cash deficits, less any surpluses, accumulated over prior years. The problem, however, is that the

Robert S. Kaplan is the Marvin Bower Professor of Leadership Development, Emeritus, at Harvard Business School. David M. Walker is the Founder and CEO of Comeback America Initiative and former Comptroller General of the United States and head of the U.S. Government Accountability Office

This white paper is in draft form and distributed for purposes of comment and discussion only. It may not be reproduced without permission of the copyright holder. Copies of white papers are available from the authors.

public debt reported on the nation's balance sheet massively understates the entirety of its existing commitments for items such as future civilian and military pensions and retiree healthcare, Social Security, Medicare and a range of other huge promised government obligations and guarantees. Solving the deficit and the debt problems requires different approaches, and while recent legislative deals in Washington have focused on how to solve the shorter-term deficit (e.g. 10 year) problem, they have systematically ignored the primary drivers of our structural deficits that are more likely to produce a U.S. debt crisis.

Furthermore, the debate in Washington has failed to recognize that the burden of meeting the mounting debt has already contributed a recent decline in the nation's economic competitiveness. For Americans to enjoy high and rising living standards, the U.S. must continue to attract and retain innovative and growing companies and people. Just four years ago, the U.S. ranked 1st out of 144 nations in the World Economic Forum's Global Competitive Index. Now it has dropped to 7th with further declines likely unless we change our policies and priorities.

Admittedly, local innovation and entrepreneurship in the private sector drive much of an economy's competitiveness. But government plays an important role too. Competitiveness requires the government to establish reasonable and competitive tax and international trade policies and a cost-effective regulatory environment, encourage competition, and a predictable judicial system to enforce contractual agreements. Government must also invest in critical transportation, energy, and information infrastructure, scientific research, and education and training. The recent mismanagement of the nation's finances has severely constrained the ability of the nation's government to make the valuable investments that enhance economic growth and improve current and future competitiveness.

Bill Clinton, when he campaigned for president in 1992, observed that the government was "spending more on the present and the past, and building less for the future." He proposed, but never implemented, a new governmental budget process that would consist of three categories:

1. Past: interest on debt and pensions and health benefits for retired government workers
2. Present: transfer payments and current governmental operations, and
3. Future: spending on research and development, infrastructure, training and education.

Clinton's espoused goal was to constrain the amount spent on the past and the present, so that more governmental funds would go towards creating a better future for our children and

grandchildren¹. Just the opposite occurred, however, and especially after 2002, the financial problem has gotten far worse.

To keep the government on a sustainable fiscal path, with the discretion to make investments that benefit the future, we must solve the short-term economic and the long-term structural debt challenges simultaneously. Those who advocate that solving debt crisis is not an urgent priority ignore the enormous future obligations and liabilities that are not reported on the governmental balance sheet. The gap between what the government measures today as its debt, and what it should be measuring helps to conceal the true problem, which enables political leaders to delay taking the difficult but sensible actions today.

In this paper, we first seek to correct this deficiency in the debate about the magnitude of the debt problem by identifying all the debt and obligations that the U.S. government has already assumed, as of September 30, 2012 (end of fiscal year (FY) 2012), the last time for which we have credible estimates. Secondly, we seek to explain how these mounting obligations affect our country's current and future economic competitiveness.

The True Financial Condition of the United States

Since 2000, the nation's reported total debt outstanding has tripled – to nearly \$17 trillion, with the interest on this debt having to be paid every year into the future. While this is indeed troubling, the total of U.S. liabilities and obligations are far higher. The federal government's total financial challenge must include consideration of its off-balance sheet obligations, especially our country's promises for future Medicare and Social Security payments, which, as of fiscal 2012, totaled nearly \$50 trillion². Also off the "official" balance sheet is the more difficult-to-quantify implicit commitment of the federal government to act as the "insurer of last resort." The government has consistently provided extensive aid to localities damaged by natural disasters – earthquakes, floods, hurricanes, and tornadoes – as well as to manage man-made disasters, including the recent financial crisis and defaults on private pension plans and student loans. All these off-balance sheet obligations, while technically not "federal debt,"³ have all the economic characteristics of debt. They represent future cash claims that the federal government must meet before spending any of its tax revenues on discretionary (non-mandatory) payments. Therefore, all of these elements must be considered, and, where

¹ While probably not what Clinton had in mind, we believe that Social Security and Medicare payments to the elderly should be classified as a legacy of the past. Funds could have been set aside, during these recipients' working and productive lifetimes, to fund their retirement and health expenses. But with Social Security and Medicare operating largely as pay-as-you-go systems, current taxes must be used to pay for current benefits. This distinction, however, between past and current payments, is not critical for our argument that more government resources should be shifted to benefit the future.

² Based on the 75-year horizon required by the Trustees of Social Security and Medicare and incorporated into the consolidated U.S. Financial Statements. Note 14. Page 93, <http://fms.treas.gov/fr/12frusg/12frusg.pdf>

³ Reference Supreme Court decision on this issue.

possible, estimated and accounted for when considering the true financial position of the federal government⁴.

On Balance Sheet

The balance sheet is the starting point for examining the true financial position of the federal government. The on balance sheet liabilities of the federal government at the end of FY 2012 totaled \$18.8 trillion (see Table 1), larger than U.S. GDP. The largest explicit liability was the \$11.3 trillion public debt, which consisted of all federal debt⁵ held by individuals, corporations, state and local governments, foreign governments, and other entities outside the United States Government, less federal financing bank securities. This is the most commonly used measure of the U.S.'s current liability position. Sixty-three percent of the public debt consists of Treasury notes with maturities of between one and ten years. Most of these Treasury notes were issued at very low interest rates, such as the 2% average for notes issued in 2012. The low coupon rates on outstanding Federal debt create an exposure to interest rate risk without precedent in U.S. history. When the U.S. Treasury department refinances this debt in future years, the interest rate will likely be much higher and the interest expense component in the federal budget will escalate enormously. In fact, the non-partisan Congressional Budget Office estimates that net interest payments in FY 2023 will be over \$857 billion, up from about \$220 billion in FY 2012. The resulting increase in interest expense will serve to further complicate the federal government's fiscal challenges and place additional impediments to investing for future competitiveness.

⁴ While not discussed in this paper, there are other methods for measuring the nation's fiscal condition, including fiscal gap analyses and inter-generational accounting, which attempt to account for both past and future obligations and the resulting disparate impacts across age cohorts.

⁵ The Treasury-issued securities include interest-bearing marketable securities (bills, notes, bonds, and inflation-protected); interest-bearing nonmarketable securities (government account series held by deposit and fiduciary funds, foreign series, State and local government series, domestic series, and savings bonds); and non-interest-bearing marketable and nonmarketable securities (matured and other). Marketable treasury securities, with differing interest rates and maturity rates, make up 95% of the debt held by the public. Note 14. Page 93, <http://fms.treas.gov/fr/12frusg/12frusg.pdf>

Table 1: U.S. Liabilities September 30, 2012

(In Billions of Dollars)	2012
Accounts payable	\$ 65.2
Federal debt securities held by the public and accrued interest	11,332.3
Federal employee and veteran benefits payable	6,274.0
Environmental and disposal liabilities	339.0
Benefits due and payable	166.2
Insurance and guarantee program liabilities	156.4
Loan guarantee liabilities	74.6
Liabilities to Government-sponsored enterprises	9.0
Other liabilities	432.6
Total liabilities	<u>\$ 18,849.3</u>

The other \$7.5 trillion of liabilities on the balance sheet at the end of FY 2012 relate to obligations of the Government resulting from prior actions that require future financial payments.⁶ These commitments represent another significant claim of the government's financial resources. The largest component (\$6.3 trillion) of these "other liabilities" is the unfunded liability for the pension and retiree health obligations of federal government employees, civilians and military. In this respect, the federal government's accounting is superior to that of the private sector and state and local governments by reporting the full unfunded obligation to its current and past employees. The same accounting, however, is not applied to recognize the federal government's unfunded obligations for its Social Security and Medicare programs, a topic we discuss in a subsequent section.

Intragovernmental Holdings

The assets of the Social Security (OASDI) and Medicare Hospital Insurance (HI), and Supplementary Medical Insurance (SMI) trust funds are special non-marketable U.S. Treasury securities, called intra-governmental holdings (IGHs).⁷ At end of FY 2012, these IGHs totaled \$4.9 trillion (see Table 2). They are not, however, currently counted as a component in the debt held by the public, nor shown as a liability on the balance sheet, even though they are fully guaranteed by the U.S. government and must be redeemed, in cash, when the assets are used to pay the trust funds' obligations. The IGHs arose when the various government programs, such as Social Security Old-Age, Disability and Survivors program, and the Office of Personnel Management's Civil Service Retirement and Disability program, ran surpluses in the past (i.e., they collected more program revenue in a given year than they paid out to beneficiaries). The trust funds bought these special debt securities with their surplus cash, and the federal

⁶ Treasury

⁷ Treasury Notes to the financial statements note 26 p. 132, <http://fms.treas.gov/fr/12frusg/12frusg.pdf>

government used the proceeds to finance part of its annual operating expenses. The situation has now been reversed as Social Security and Medicare trust funds now run deficits, which require them to sell some of their IGHs to pay current beneficiaries and service providers. Government actuaries forecast that Social Security (OASDI) trust fund will be completely depleted in 2033, and that the Medicare (HI) trust fund's exhaustion will occur nine years earlier, in 2024.⁸

Since these IGHs do represent a large component of federal debt outstanding, they should be included on the Federal balance sheet as liabilities, bringing total Federal debt to \$16.2 trillion, as of September 30, 2012 and total Federal liabilities to \$23.7 trillion, or about 150% of GDP.

Table 2: Intragovernmental Holdings September 30, 2012

(In Billions of Dollars)	2012
Social Security Administration, Federal Old-Age and Survivors Insurance Trust Fund	\$2,586.7
Office of Personnel Management, Civil Service Retirement and Disability Fund	826.5
Department of Defense, Military Retirement Fund	376.4
Department of Health and Human Services, Federal Hospital Insurance Fund	228.3
Department of Defense, Medicare-Eligible Retiree Health Care Fund	176.1
Social Security Administration, Federal Disability Insurance Trust Fund	132.3
Department of Health and Human Services, Federal Supplementary Medical Insurance Trust Fund	69.3
Department of Energy, Nuclear Waste Disposal Fund	49.6
Office of Personnel Management, Postal Service Retiree Health Benefits Fund	45.3
Office of Personnel Management, Employees Life Insurance Fund	41.3
Federal Deposit Insurance Corporation Funds	41.0
Department of the Treasury, Exchange Stabilization Fund	22.7
Office of Personnel Management, Employees Health Benefits Fund	21.3
Pension Benefit Guaranty Corporation Fund	21.1
Department of Labor, Unemployment Trust Fund	20.7
Department of State, Foreign Service Retirement and Disability Fund	16.9
Department of Transportation, Airport and Airway Trust Fund	10.4
National Credit Union Share Insurance Fund	10.3
Department of Transportation, Highway Trust Fund	10.0
All other programs and funds	90.4
Subtotal	4,796.6
Total Net Unamortized Premiums/Discounts Intragovernmental	56.3
Total intragovernmental debt holdings, net	\$4,852.9

⁸ The calculation of the Social Security and Medicare debt (described in the next section) treats these IGHs as trust fund assets, a component to generate future cash flows for the two trust funds. If the IGHs were not included in this calculation, the deficit of these two programs would be \$4.9 trillion larger than currently reported. By not counting the IGHs as a federal obligation, \$4.9 trillion of government debt simply disappears.

Some claim that IGHs should not be counted as liabilities of the federal government, by arguing that IGHs represent a paper transaction between two branches of the government, essentially an unfunded commitment from one part of the government to make a payment to another part of the government. We disagree, because these IGHs represent a real future claim on government revenue. Suppose, alternatively, that the government, instead of selling its bonds to the trust funds, sold them to external creditors. Then, at a future time, when the trust fund was running a deficit and the previously issued bonds came due, the government would have to make two payments; one to redeem the security held by an external creditor and a second to the trust fund's beneficiaries. With the fund holding the government bond in its trust fund, the government must make only a single payment since the redemption amount is passed along to the trust fund beneficiaries. In addition, the "Investments in special non-marketable U.S. Treasury securities... are backed by the full faith and credit of the U.S. Government"⁹, and these holdings are guaranteed by section 4 of the 14th amendment to the Constitution which states: "*The validity of the public debt of the United States, authorized by law ... shall not be questioned. ...*" For these and other reasons, we believe that liability recognition for IGHs is appropriate.

Off-balance sheet

Total explicit liabilities of nearly \$24 trillion, however, still substantially understate the country's financial obligations. The country has huge off-balance sheet obligations and federal guarantees that analysts frequently omit when calculating the federal government's financial position. These obligations and program guarantees are many times higher than the public debt, and therefore represent the true threat to the fiscal solvency of the government and future economic competitiveness. Estimates of the magnitude of the obligations and guarantees are difficult to find; they are usually buried in footnotes to various governmental financial statements, causing their magnitude to often be ignored when analyzing the government's financial position. Their omission distorts the discussion about the urgency of addressing the looming fiscal and competitiveness crises.

Statement of Social Insurance

Social insurance promises make up a large majority of the government's off-balance sheet burden. Footnote 26 in The Statement of Social Insurance estimates the actuarial present value of the projected future revenue and expenditures for Social Security (Federal Old-Age, Survivors and Disability Insurance), Medicare (part A, B, and D), Railroad Retirement, and Black Lung social insurance programs. The open group total present value, over a 75-year period, of future expenditures, as of end of FY 2012, in excess of revenue for these programs is \$38.6 trillion¹⁰, with Social Security accounting for \$11.3 trillion¹¹ and Medicare \$27.2 trillion¹² of

⁹ Treasury Notes to the financial statements Note 26, Page 131, <http://fms.treas.gov/fr/12frusg/12notes.pdf>

¹⁰ Treasury, The Government's Financial Position and Condition, Page 4, <http://fms.treas.gov/fr/12frusg/12frusg.pdf>

¹¹ Of this amount about \$2.7 trillion was backed by IGHs

this amount.¹³ This \$38.6 trillion amount is more than twice the debt held by the public, and yet even this amount likely understates the true obligation. An illustrative alternative scenario, included in the notes to the financial statements, suggests that the Medicare obligation could be \$10 trillion greater, with the difference arising from different assumptions about the consequences from the Affordable Care Act.

Implicit Guarantees

In recent years, the financial cost of natural disasters and financial meltdowns fell on the shoulders of the federal government. These substantial sums are almost impossible to calculate in advance and require immediate response in terms of financial resources. This was apparent after Hurricane Sandy in 2012, for which Congress approved \$61 billion in federal aid, \$62.3 billion in emergency federal funding for Hurricane Katrina in 2005, and the 2008 banking crisis for which Congress appropriated hundreds of billions in bailouts to financial institutions and automobile companies, most of which, fortunately, was eventually repaid. The implicit guarantees of the federal government for natural and man-made disasters, and private pension and other guarantees are not transparent or readily measurable. But they do represent yet another claim on future government resources that limits its flexibility to invest in current and future competitiveness.

In summary, a conservative estimate at the end of FY 2012, using the information on the balance sheet and in the notes to the financial statements, shows that the federal government had accumulated about \$70 trillion worth of explicit liabilities, commitments and contingencies, and unfunded obligations,¹⁴ without recognizing the future cost of the difficulty-to-estimate magnitudes of government guarantees and bailouts. We can be sure, however, that the realized magnitudes of such bailouts will be far greater than zero. Also, the governmental estimates of the differences between net revenues and expenses for social insurance programs ignore all deficits after 75 years. But as with government guarantees and bailouts, the magnitude of the deficiency beyond 75 years is very large due to known demographic trends and rising health care costs. In fact, the most recent Trustees Reports for Social Security and Medicare estimate that the perpetuity numbers for these programs are \$ \$8.6¹⁵ and \$ \$5.3 trillion¹⁶ respectively. While there is clearly not a perfect way to account for everything that the federal government has promised to current and future generations, the current and conservative estimate of \$70 trillion in debt and unfunded obligations as of September 30, 2012 makes it clear that the

¹² Of this amount about \$300 billion was backed by IGHs

¹³ Treasury Management's Discussion and Analysis Table 1, Page 3 <http://fms.treas.gov/fr/12frusg/12frusg.pdf>

¹⁴ Based on a 75 year present value calculation Note 14, Page 91, <http://fms.treas.gov/fr/12frusg/12frusg.pdf>

¹⁵ 2012 Social Security Trustees Report, Page 4, <http://www.ssa.gov/oact/tr/2012/tr2012.pdf>

¹⁶ 2012 Medicare Trustees Report, Page 75, <http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2012.pdf>

nation's current financial condition is far worse than advertised and its fiscal trajectory unsustainable and economically dangerous.

How We Got Here

In the hundred years between 1912 and 2012, federal governmental spending grew from 2% of GDP to 23%, with a large component of the increase occurring in the past 12 years. The Clinton administration ran governmental surpluses for the first time in decades, helped by soaring tax revenues from capital gains and exercised stock options from the NASDAQ/dot.com bubble, and reduced defense spending from the peace dividend after the end of the Cold War with the Soviet Union. In January 2001, the non-partisan Congressional Budget Office (CBO) projected a cumulative surplus of \$5.6 trillion for 2002–2011, and many expressed concern about how to cope with ten more years of forecasted governmental surpluses.¹⁷

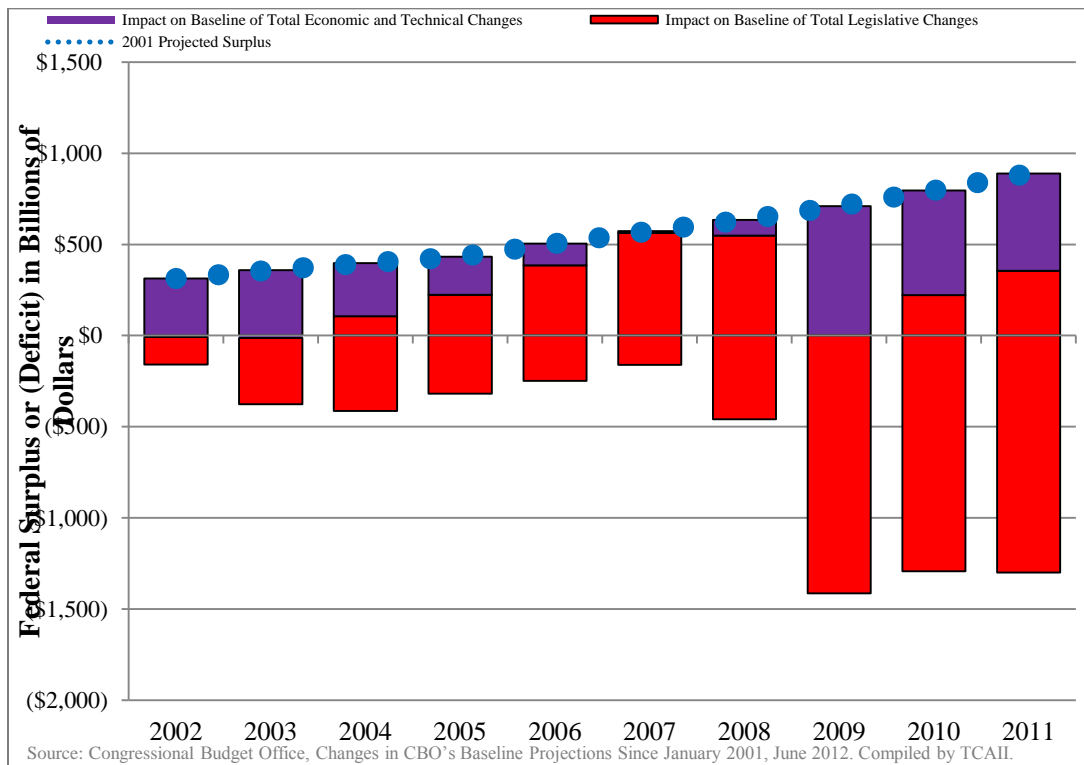
These huge surpluses clearly did not materialize as tax revenues fell after the stock market decline and accompanying economic slowdown in 2001 and 2002, followed by Republican tax decreases, Democrat spending increases, two undeclared and unfinanced wars, and further increases in social insurance programs for healthcare, especially Medicare Part D and the Affordable Care Act. The deficits from 2002 through 2011 accumulated to \$6.1 trillion – a swing of \$11.7 trillion from the January 2001 projections (see Figure 1).¹⁸ U.S. debt tripled during this period, interest expense on the debt increased by \$1.4 trillion and the government's unfunded healthcare obligations for the nation's seniors rose by \$8 trillion with the passage of the new Medicare Part D (drug) benefit alone. These policy choices, along with the recent economic recession, created a perfect fiscal storm, placing us in the current situation of annual federal deficits of 6% of GDP and federal debt and unfunded obligations of more than 4 times GDP.

¹⁷ Of course, this analysis ignored the large unfunded obligations of the nation's social insurance programs.

¹⁸ CBO, Changes in CBO's Baseline Projections Since January 2001. , June 7, 2012

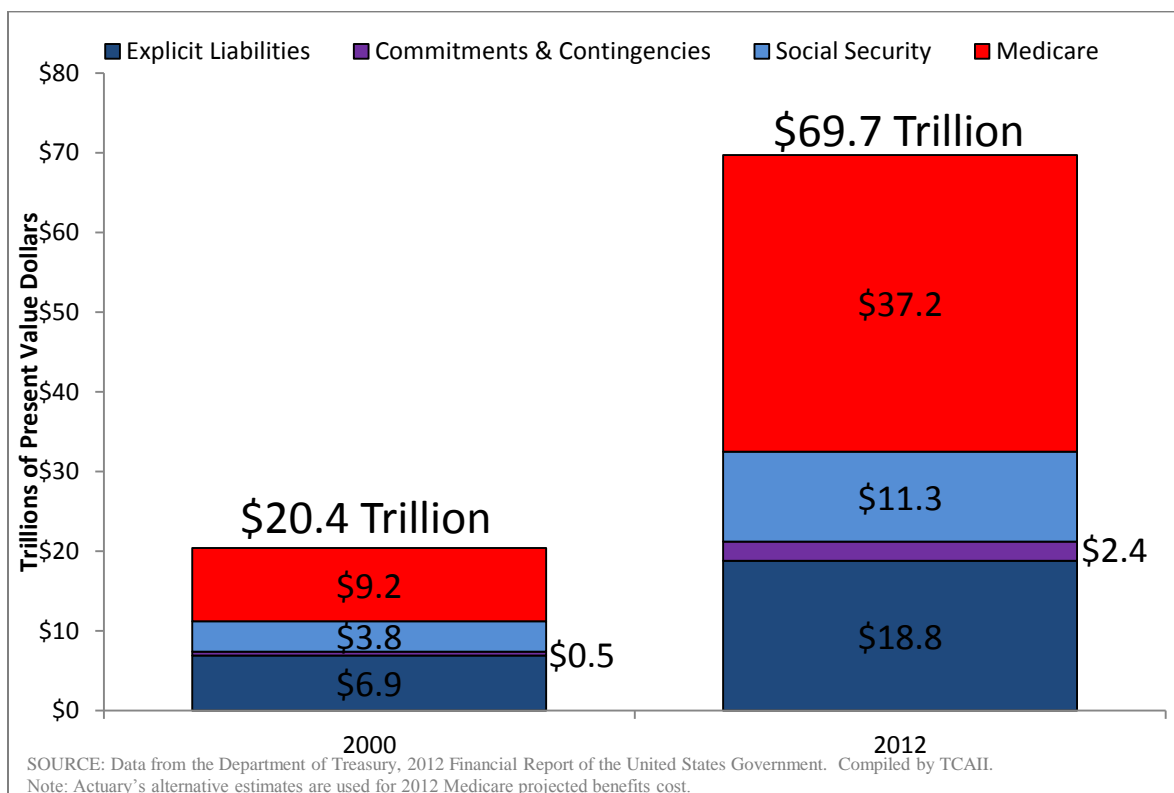
<http://www.cbo.gov/sites/default/files/cbofiles/attachments/06-07-ChangesSince2001Baseline.pdf>

Figure 1: From Surplus to Deficit



The past ten years have arguably been the most fiscally irresponsible in our nation's history, as total federal liabilities and unfunded obligations soared from about \$20 trillion to almost \$70 trillion (see Figure 2).

Figure 2: Growth in Financial Obligations, 2000 - 2012



But the nation’s poor financial condition is not just a recent phenomenon. It is the result of cumulative policy choices made by both political parties over the past century. Spending on the mandatory portion of the federal budget – which includes social insurance programs, federal employee retirement benefits and interest on the national debt - was 3% of the budget in 1912, 49% of the budget in 1972, 64% of the budget in 2012, and is projected by the Congressional Budget Office to become 76% in 2023, with higher percentages projected into the indefinite future.¹⁹ This trend is the inevitable result of our legislative and political leadership overpromising on retirement and healthcare, promising low taxes, emphasizing current consumption, neglecting investments for the future, and consistently ignoring key demographic and economic trends. The mandated spending on the past and the present has now begun to crowd out spending for the future, especially the discretionary governmental spending on critical investments that sustain and increase America’s competitiveness. Paying the interest on the public debt and meeting our social insurance promises have driven mandated governmental spending to unsustainable levels, which will only get worse over time absent a change in course.

¹⁹ CBO document Table 1.1 Page 9, <https://www.cbo.gov/sites/default/files/cbofiles/attachments/43907-BudgetOutlook.pdf>

Naïve Solutions to the Debt Problem

Countries, in the past, have used two different solutions when confronted with massive debt that they could not service. Several simply printed money to pay the debts, leading to high inflation that enabled the country's fixed coupon, long-duration debt to be repaid in a devalued currency. Inflation, however, is not a feasible option to solve the US financial burden challenge. Much of the recently-issued debt is short duration, and will mature and have to be re-financed, well before the full benefits of inflation have had a chance to work, at interest rates that reflect current and expected future inflation rates. Also, the largest component of the US financial burden is for future payments in its social insurance programs, and these programs are already indexed for inflation (some believe over-indexed leading to the current recommendation to switch to an alternative inflation adjustment mechanism). Health care costs have historically risen at a faster rate than inflation and economic growth. So running an inflationary economy makes the liability worse, not better, particularly when taking into account the disruptive influences of high inflation on a well-functioning and competitive economy.

The second alternative to a crushing debt load is default, an action followed recently by countries such as Argentina, Iceland, Greece, and Cyprus. For the U.S., the default could be to its public debt holders, but the government could also default on the cash payments it promised to current recipients of its social insurance programs. If the government decides to slow the future growth in social insurance benefits, it should announce and put into law any program changes long in advance of when they take effect. Such advance notice allows future beneficiaries to have many years to adjust to the changes. That is why we strongly urge acting on the U.S. financial burden problem today, not in future years when promised benefits can no longer be paid in full.

States Have Fiscal Challenges Too

The problems associated with accounting for future costs and "what if?" scenarios are not exclusive to the federal government. Corporations have a similar issue when they make commitments to their employees through defined-benefit pension plans and OPEB (other post-employment benefits) paying some or all of retirees' health care costs. Private sector accounting, however, requires that corporations' commitments for pensions and OPEB be recognized as liabilities of the company, along with their public and private debt obligations. Companies calculate and update each year, the present value of all their post-retirement commitments, (pension and health care benefits) and recognize the unfunded portion of these amounts as liabilities on their financial statement, along with extensive description and measurement of these obligations in the financial statement footnotes, as mandated by the Financial Accounting Standards Board and the Securities & Exchange Commission.

In addition to the liability recognition, companies record an expense, on their income statement, on the annual increase in pension obligations for current employees plus the interest on the unfunded liabilities (total NPV of future employee commitments less the fair value of any assets in pension and other retirement plans). This is the beauty and the power of accrual accounting – the ability to reflect the economics of the firm correctly, independently of annual cash inflows and outflows. The annual cash expenditures on pensions and retiree health benefits reflect how the company chooses to finance its liabilities, either through explicit payments or through deferral, but not the underlying economics of its obligations and annual expenses for these benefits.

The Governmental Accounting Standards Board (GASB), in June 2012, promulgated that state and local governments must begin to disclose the full amount of their unfunded pension liabilities on the balance sheet²⁰. They also likely will require similar recognition and disclosure for retiree health care obligations in the near future. This improved accounting will show the massive, but currently hidden, obligations that states and localities have already incurred for their current and future retirees.

In Table 3, we present the total financial liabilities and unfunded obligations (burden) of 11 states to show the range of indebtedness that currently exists. The financial burdens per taxpayer shown in Table 3 and total burden/GDP demonstrates how significant the variances can be between states. Four “red Presidential states” – Arizona, North Carolina, Georgia and Texas – have ratios of net financial burdens per dollar of GDP between 2 and 4%, while four “blue Presidential states,” states – Connecticut, Illinois, Massachusetts, and New Jersey – have ratios averaging 22%. The “blue states” estimated unfunded pension and OPEB obligations, which are included as a subcomponent in Table 3, are already sobering, but they considerably understate their true magnitudes since most use interest and trust fund asset earning rates far above their current borrowing and investment return rates to discount the future cash flows for retiree benefits.

Table 3: Selected State’s Financial Burdens (2011 data)

State	Each Taxpayer's Financial Burden	Net Liabilities (Billions)	GDP (Billions)	Liabilities % of GDP
Arizona	3,330	6	258	2.3%
California	23,500	259	1,959	13.2%
Connecticut	50,900	63	230	27.4%
Florida	2,700	15	754	1.9%
Georgia	5,000	13	419	3.0%

²⁰ GASB statement No. 67 & 68; issued June 2012. . No. 67:

http://www.gasb.org/jsp/GASB/Pronouncement_C/GASBSummaryPage&cid=1176160219444

No. 68: http://www.gasb.org/jsp/GASB/Pronouncement_C/GASBSummaryPage&cid=1176160219492

Illinois	38,500	159	671	23.7%
Massachusetts	24,100	56	392	14.2%
New Jersey	37,000	110	487	22.5%
New York	21,100	127	1158	11.0%
North Carolina	14,300	36	440	8.3%
Texas	8,400	55	1,308	4.2%

Residents and companies in states with high debt burdens will face a double jeopardy in the near future as they simultaneously service both their federal and state debt and obligations. The high variability of pension and retiree health burden across states in the U.S. creates a serious domestic competitiveness issue at state and local levels, and with additional constraints that states cannot print money, and have fewer resources to service their obligations. If state and local taxes must rise to service total debt obligations, we can expect a continuation and likely acceleration in the migration rates of people and companies from high-burden to low-burden states.

Why Debt Impacts Competitiveness

The federal government, unlike most states, does not have to balance its budget each year. Therefore, it could make sense for the federal government to run deficits for short-term counter-cyclical spending and to fund certain types of investment-oriented spending. For instance, federal borrowing to invest in areas such as properly-designed and effectively-implemented infrastructure programs, which can grow the economy and allow future generations to prosper, may be beneficial. Economists would characterize such investments as delivering positive net present value (NPV) – producing more benefits in the future than their current cost today. Such positive NPV investments better prepare future generations to compete economically and enjoy a higher standard of living, so burdening them with a portion of the debt required to fund such spending is appropriate. Yet borrowing to fund today's current consumption, operating expenses and to service the debts of the past, as the government is currently doing, puts the future economic competitiveness of our nation at risk. Future generations will have to pay for their parents' past consumption as well as their own, while the economy is growing slowly and with fewer high wage jobs.

Despite the already enormous U.S. financial burden position, Keynesian economists, such as Paul Krugman and Martin Wolf of the FT, continue to argue that the government should not solve its short-term deficit problem by raising taxes or lowering spending. They urge the government to continue to stimulate our current economy by borrowing at today's very low interest rates to finance the gap between government revenues and expenditures. This may be valid advice for the near term since today's very low interest rate obviously eliminates the risk of crowding out private investment. But such analysis ignores the balance sheet effects from borrowing today to pay for today's consumption.

The optimal set of decisions over a 25-year horizon is not to make a sequence of 25 optimal one period decisions. The optimal decision in the initial year of a 25-year decision period must reflect not only its short-term effects but also its consequences in all future years. Every trillion dollars we borrow today, even at a zero interest rate, requires higher mandatory interest payments when the U.S. Treasury inevitably re-finances the debt in the future, at much higher interest rates. If the future interest rate is, say 5%, then every \$1 trillion borrowed today adds \$50 billion per year to future deficits. This is an extra burden on future government's ability to invest for competitiveness and higher living standards. With just the \$16.2 trillion in reported federal debt²¹, every one percent (100 basis point) increase in future interest rates already adds approximately another \$162 billion in annual interest to future mandatory spending. In fact, under current law, the CBO projects net interest on the debt held by the public to exceed \$970 billion by 2023.

In the absence of any action by Congress and the President, the payments for these obligations will be made in each future year, along with the interest and principal payments on previously issued debt, with the payments taking precedence over any other type of governmental spending. Discretionary spending, which encompasses all of the basic obligations of the federal government in the Constitution, will decline an additional 36% from its 30-year average to 5.5% of GDP, and remain on a downward trajectory beyond these historically low levels. This crowding out effect in the budget is more worrisome than the current deficit or debt level, because as the federal government commits fewer funds to the activities that made this country the most competitive in the world, and simultaneously asks its citizens and businesses to pay more in taxes, economic disruption will most assuredly occur at some point.

This decline in economic competitiveness and the squeezing of discretionary spending will further erode the ability of the federal government, which has already inadequately invested in the country's future, to make up this gap. In fact, as noted earlier in this article, the U.S.'s competitiveness ranking has already begun to decline.²² If the federal government does not begin balancing out how and where it spends, and return our nation to, "the competitive economy" it was in years past, the yawning gap may grow too large and become insurmountable.

Aside from squeezing out investments, the imprudent path the federal government is currently on, and its seeming inability to make sensible adjustments to policies and programs, some designed almost 70 years ago, creates economic uncertainty about future levels of taxation and spending. This uncertainty makes businesses, individuals, and investors very hesitant to choose the U.S. as their location of choice for investment.

²¹ As of the end of FY2012. Note 14, Page 91, <http://fms.treas.gov/fr/12frusg/12frusg.pdf>

²² World Economic Forum Table 4, Page 12, http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2012-13.pdf

If the government fails to reform its obligations, the inevitable result would be politically and economically unsustainable levels of taxation, the expectation of which results in a negative feedback loop in the private sector. Capital suppliers and talented individuals calculate the return to their investments of financial and human capital **after** subtracting their tax burden to pay for interest on the national debt, current government services, transfer payments, and public investments. High expected future taxes dramatically reduce the expected future returns to human and financial capital, making the US a far less attractive place to build sustainable and competitive enterprises.

Admittedly, local innovation and entrepreneurship in the private sector drive much of an economy's competitiveness, but the government must also play an important role. Competitiveness requires government to establish reasonable and competitive tax policies as well as regulations that encourage competition and ensure compliance with legal requirements and contractual agreements. Government must also spend to invest in critical transportation and information infrastructure, scientific research, education and training. The United States government is underinvesting in crucial areas and has overpromised on almost every front. Businesses and individuals know this, and yet the government has failed to realize that the economic revival they seek will only come once they have looked under the hood and fixed the underlying problems. The time to begin is now.