Motley Fool Stock Advisor Special Report

Everything You Need to Know About the National Debt

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The Museum of American Finance rests in the heart of Wall Street in a building that once served as the headquarters of the Bank of New York — one of the oldest banks in the country, and one that counts Alexander Hamilton as a founder. I came to the museum to visit its CEO, David Cowen.

Cowen waves me over to a small glass case, which holds what he says is his favorite exhibit. Inside is a faded certificate with some fancy scrawl.

"Do you know what this is?" he asked. I didn't.

"This is America's first bond. These are George Washington's bonds. This is the origin of our national debt!" he beams. It's a financial historian's dream.

The bond was for $65 million, left over from the Revolutionary War. In the succeeding 200-plus years, America's national debt and the annual budgets that affect it have bounced around chaotically, undergoing periods of roaring growth when debt is piled on to finance wars and recessions, to long stretches of calm when debt as a share of the economy falls.

Through it all, we are left with more than $16 trillion of debt as of early 2013. About $10 trillion of that represents deficits of the last decade, driven by tax cuts, two wars, stimulus packages, bailouts, and the worst recession in 80 years.

Our debt's recent growth is unsustainable. Rightly, Americans are concerned. A 2009 NBC/Wall Street Journal poll showed 8 in 10 Americans were concerned about the national debt. By 2013, with debt still rising but annual deficits considerably smaller, that figure only inched down to 7 in 10. Clearly, the nation's growing debt poses a long-term threat if not checked.

But in the short run, perhaps more dangerous than the debt itself are the misconceptions, falsehoods, and fibs that come along with it.

While most Americans tell pollsters they are concerned about the national debt, an equally high percentage show surprisingly little understanding of the factors driving deficits, or even what the government's budget looks like. One 2011 poll showed one-in-five Americans think foreign aid takes up 30% of the federal budget, when the actual figure is closer to 1%. The average respondent estimated the government spends 5% of its budget on PBS and public radio, when the real number is a tiny fraction of 1%. Just 40% of those surveyed correctly identified that Social Security, Medicare, and defense make up the majority of the federal budget. Discussing the national debt elicits emotion and opinions driven by political ideology. Neither is conducive to facts.

What is the truth? The purpose of this report is not to advocate any particular policy, party, or moral view. It's to simply lay out the facts of the federal budget and the national debt.

Let's dig into some numbers.

Just the facts: How the Government Spends Your Money and Taxes Your Income

Federal spending falls into two broad categories: Mandatory and discretionary.

Mandatory spending are things that don't require a specific budget each year. Based on current law, they are areas of spending that will take place regardless of what Congress and the president agree on in the annual budget. Things like Social Security, Medicare, unemployment benefits, food stamps, veteran's benefits, and government employee pensions are all part of mandatory spending. Of the $3.7 trillion the government spent will spend in 2013, more than $2.6

trillion will be "mandatory."

Congress and the president can, at any time, modify the laws to change what is considered mandatory by, say, re-writing Social Security laws to reduce benefits. But doing so falls outside of the annual budgeting process and is generally seen as breaking long-standing contracts between citizens and their government. The size of mandatory obligations combined with its relative permanence helps explain why it's so difficult reduce government spending.

Discretionary spending, on the other hand, requires an annual appropriation through the traditional budget process. Things like defense spending, highway spending, science and education spending, energy, courts, and transportation are all part of discretionary spending.

With the definitions out of the way, let's take a look at how the government spends your money (segments shaded in blue are mandatory):

Segment	**Amount spent, 2013 (billions)**	**As a Percent of GDP, 2013**	**Average Percent of GDP, 1960-2012**
Social Security	$818	5.12%	3.93%
National Defense	$660	4.13%	5.43%
Income Security	$564	3.52%	2.60%
Medicare	$510	3.19%	1.46%
Health	$372	2.32%	1.12%
Net interest	$223	1.39%	1.97%
Veterans Benefits	$140	0.87%	0.69%

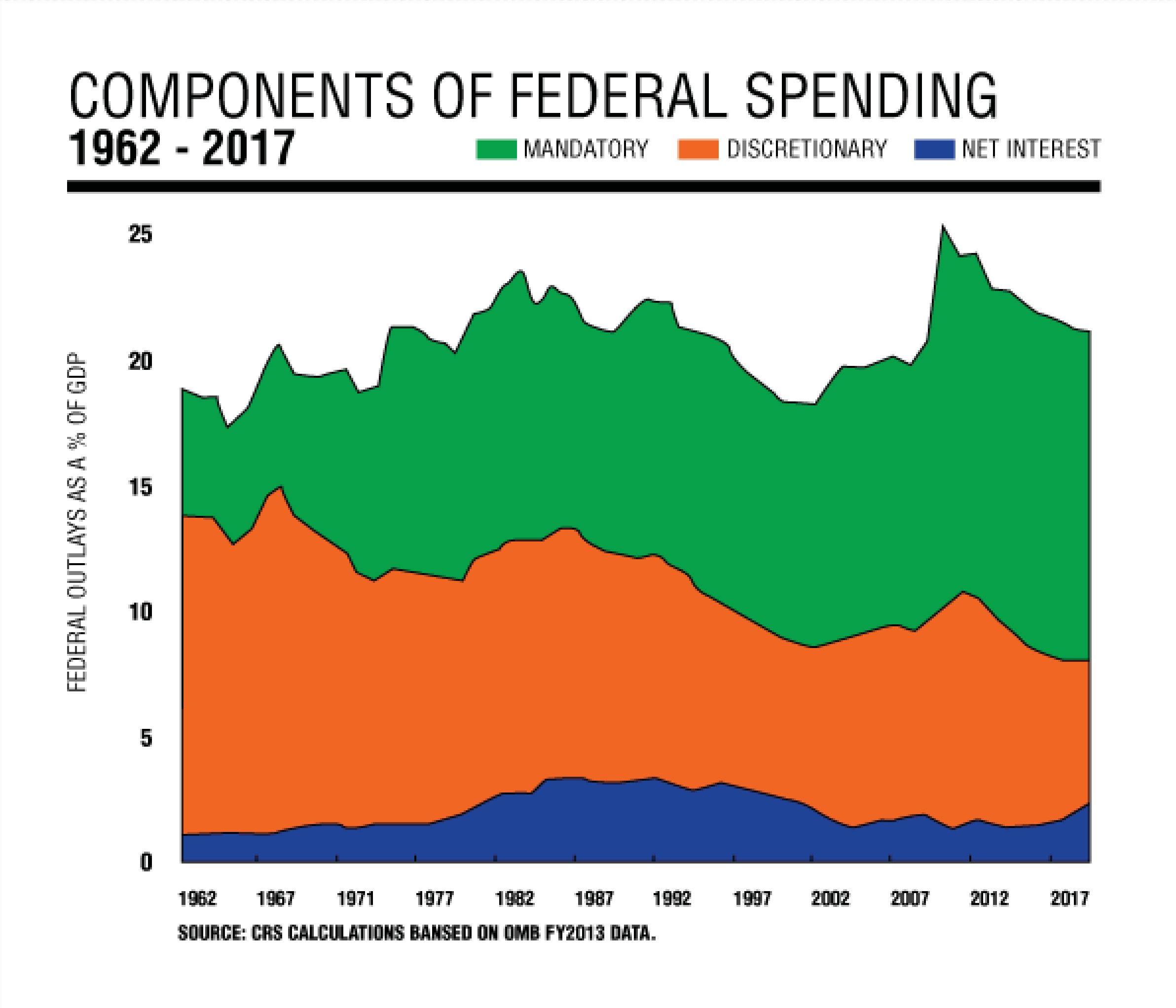
Transportation	$94	0.59%	0.62%
Education and Training	$85	0.53%	0.70%
Administration of Justice	$61	0.38%	0.20%
International Affairs	$57	0.36%	0.36%
Natural Resources and Environment	$38	0.24%	0.32%
Community and Regional Development	$38	0.24%	0.19%
Science, Space, and Technology	$31	0.19%	0.28%
General Government	$30	0.19%	0.26%
Agriculture	$27	0.17%	0.33%
Commerce and Housing Credit	$18	0.11%	0.22%
Energy	$15	0.09%	0.11%

Undistributed offsetting receipts	($95)	(0.59%)	(0.71%)
Total Federal outlays	**$3.68 trillion**	**23.0%**	**20.1%**

Source: Office of Budget and Management and author's calculations.

Yes, federal spending as a percent of gross domestic product is currently above the long-term average. But what's driving the abnormally high spending may not be what you think. Defense spending, often cited as a culprit of runaway largesse, is actually below the long-term trend — although the U.S. spends far more than any other country in the world. Entitlements like Social Security and Medicare are above average, largely because of an aging population. Income security, which consists of programs like unemployment benefits and food stamps, are high thanks to the weak economy.

But most other spending categories are in line, or even below, their long-term trends. Discretionary spending as a percentage of GDP is on track to hit a half-century low by as early as 2014:



We'll get into projections of future spending later on, but now let's tackle the other side of the ledger: tax revenue.

Tax Revenue

You know what they say about life's two guarantees: death and taxes.

Government tax revenue falls into three major categories: Income, payroll, and corporate.

Income taxes come out of, well, incomes — everything from wages to capital gains. Payroll taxes, which help fund entitlements like Social Security and Medicare, come primarily out of wages, with the burden typically split between employer and employee. Corporate taxes are paid by (you guessed it) corporations, which shouldn't be confused with partnerships, sole proprietorships, or LLCs — they're part of a large and growing amount of business income that is "passed through" to its owners and taxed as individual income.

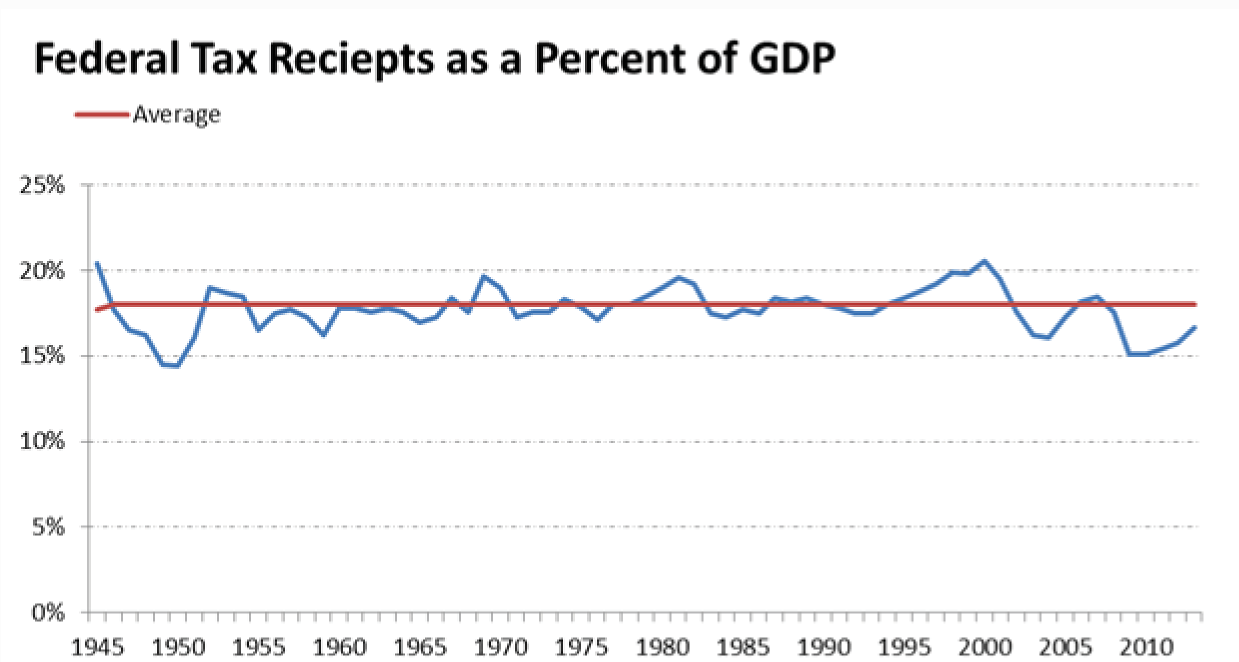
Here's how tax revenue breaks out:

		As a	Average

Segment	Collections, 2013	Percent of GDP, 2013	Percent of GDP, 1960-2012
Income	$1.2 trillion	7.5%	8.1%
Payroll	$952 billion	5.9%	5.6%
Corporate	$288 billion	1.8%	2.3%
Excise	$85 billion	0.5%	1.0%
Other	$154 billion	0.9%	0.9%
Total	**$2.7 trillion**	**16.9%**	**17.9%**

Source: Office of Budget and Management, author's calculations.

Even after the expiration of the payroll tax cut and an increase in tax rates on some high earners put in place in early 2013, tax revenue as a share of the economy will still be below the historical average in 2013:



Source: Office of Budget and Management, author's calculations.

Most of the drop in tax revenue as a share of GDP in recent years is caused by the recession and weak economy. Tax revenue falls as unemployment rises, and vice versa. When the economy was the strongest it had ever been in 2000, tax revenue as a share of GDP was at an all-time high. When it was the weakest it had been in generations in 2009, tax revenue as a share of GDP was at a 50-year low. Those aren't coincidences.

There's another component of tax revenue that is mostly hidden from view but has a very real impact on budgets: Tax deductions and loopholes, or what budget wonks call "tax expenditures." These tax deductions don't change the tax figures in the table and chart above. Rather, they are a look at foregone revenue that would have been collected had they not been law:

Deduction	**Lost Tax Revenue, 2012**
Employer-sponsored health insurance	$171 billion
Retirement contributions	$138 billion
Mortgage interest deduction	$87 billion
Accelerated depreciation of equipment	$76 billion
State and local bond interest	$39 billion
Charitable contributions	$33 billion
State and local tax	$33 billion
Various health care items	$27 billion

Social Security benefits	$26 billion
Child credit	$24 billion

Source: Credit Suisse.

Regardless of your views about taxation, the stark truth is that the government doesn't collect enough revenue to pay for the highly popular services taxpayers demand, like unemployment benefits, entitlements, and defense. If the federal government limited itself to just those three categories, scrapping everything from the FBI to air traffic control to the court system, it would still run a large annual deficit at current levels of tax revenue.

And those deficits may only get worse with time.

The Road Ahead: The Future of Government Spending

Forecasting the budget is notoriously hard. And it gets harder the further out we look. Looking one year ahead is fairly accurate, but still prone to error. Looking five years out is dangerously imprecise. Ten years out, and the track record of the smartest and most informed budget analysts isn't distinguishable from random guesses. We even have 75-year budget forecasts, which is absurd. Trying to forecast what the budget will look like in the year 2084 is no more rational than trying to forecast who will win the presidential election of 2084.

But we do know a few likely trends, and we can make reasonable assumptions about how they'll impact future budgets.

We know that the country is getting older. As the baby boom generation retires and life expectancies rise, a growing share of retirees will be supported by a lower share of workers. In 2013, 13.9% of the U.S. population is age 65 or older, according to the Census Bureau. By 2033, that figure will rise to 20%, and 21% by 2050.

Nearly all of those elderly will be eligible for Social Security and Medicare. Extrapolate what the growth in entitlement benefits means for budgets, and you get some nightmarish figures.

According to the Urban Institute, a couple with average wages retiring at age 65 in 2010 would have paid $88,000 in dedicated Medicare taxes over the course of their lifetimes (including their employers' share) but can expect to receive $387,000 in Medicare benefits. A 65-year-old couple retiring in 2020 will have paid $111,000 in Medicare taxes and can expect to receive $427,000 in benefits. These figures are adjusted for inflation and discounted to present value using a 2% real rate of return.

At current law, Medicare spending is forecast to rise from a bit over 3% of GDP today to 4.5% by 2022, and 6.7% by 2037. Put differently, if we devoted as much of our economic output to Medicare today as we're projected to in another 20 years, we'd be spending well over $1 trillion annually for that entitlement alone. Projections of higher health care spending are the single largest driver of long-term deficit growth. By far.

Social Security is also a problem, but less so than Medicare. As a share of GDP, Social Security spending is set to rise from a bit over 5% today to 6.2% by 2037, according to the Congressional Budget Office. That extra 1% of GDP would be like spending an extra $160 billion this year.

Some readers will protest that entitlement benefits aren't really part of the budget, because they've paid into the entitlement system with separate payroll taxes. The last part is true — but it doesn’t help the budget situation. You may have paid into the entitlement system, but you're likely set to receive far more back than you paid in, adjusted for inflation. That difference between the two figures creates a deficit, and the deficit becomes the responsibility of taxpayers, just like any other spending shortfall. Entitlement trust funds that represent past contributions in excess of outlays hold all of their assets in Treasury bonds that require taxpayer funding to be paid off. In theory, entitlements are segregated from the rest of the budget. In reality, it's merely an accounting formality. At the end of the day, the government is one body with revenues and expenses.

When the former doesn't cover the latter, you have a deficit. A big one, too.

So, what do we do about it?

The deficit projections for both Medicare and Social Security are scary, but potentially flawed for two reasons.

First, the rules can be changed.

In 1982, Senator Bob Dole warned that Social Security "faces insolvency in the near future." He wasn't exaggerating. Estimates at the time showed the program would go bust by 1990. Thankfully, that never happened, because in 1983, President Reagan and Tip O'Neil shook hands on a deal to reduce benefits and raise taxes to keep the program intact. Crisis averted.

Most pensions are contractual obligations that have to be paid. That's not the case for either Social Security or Medicare, as Heritage Foundation economist JD Foster explains: "Legally, they are not liabilities … Congress can at any time reduce or alter them. In contrast, state pension plans are contractual labor arrangements that are liabilities because they are legally enforceable."

The question is not whether Congress can fix entitlement growth — of course it can. It's not even *if* it will fix the problem, as it will eventually be forced by creditors. Rather, the question is *when*. Whenever the problems are fixed, the scary budget projections we rely on today may become irrelevant, just as Bob Dole's were in the 1980s.

We also need to keep in mind how bad we are at forecasting. Current forecasts of runaway health care spending rely on the assumption that the cost of medical care will continue to spiral higher at rates far greater than overall inflation, as has been the case for most of the last half-century.

But things are starting to change. Unforeseen by virtually everyone, health care cost growth has plunged to its lowest level in decades. Average spending per Medicare recipient actually *fell* slightly in 2012, according to former White House Budget Director Peter Orszag. In February 2013, the CBO lowered its estimate of Medicare's future deficit over the coming decade by $200 billion, thanks to lower health care cost growth.

Even better, a study by Harvard health care economist David Cutler estimates that not all of the unforeseen slowdown in health care spending is because of the weak economy. Instead, more generic prescription drugs, more interaction between patients and providers, and better bargaining between insurance companies and hospitals seems to have brought cost growth down faster than many imagined. Cutler estimates we may be overestimating public health spending by $770 billion over the next decade alone. If he's right, the gloomy forecasts of runaway deficits melt away at the snap of a finger.

Which would be wonderful. But what do we do about the $16 trillion debt we already have?

The Elephant in the Room: Managing a $16 Trillion Debt

America found itself burdened with more debt than it ever imagined at the end of World War II. Debt held by the public equaled 44% of GDP in 1939, and more than 120% of GDP by 1945 (the comparable figure today is about 71% of GDP.)

With the nation still shell-shocked from the Great Depression, the debt was terrifying. Many wondered how we could ever pay it off.

The answer was: We never would. But that'd be just fine.

People have finite lifespans and eventually have to pay all their debts off. Countries (and companies) with indefinite lifespans are different. They just have to figure out how to manage their debts in perpetuity.

A 1945 article in *The Wall Street Journal* was prescient: "There is little likelihood that the national debt will be reduced substantially during the next generation," it read."This means that debt management rather than debt reduction is the important problem before the Treasury in the coming years."

That's exactly what happened. From 1945 to 1980, there were only eight years when the government actually ran a surplus, and most were irrelevantly small. Yet during that period, government debt as a percent of GDP fell by three quarters, bottoming at 31% of GDP in 1981. Think about that: The debt burden fell dramatically even as we ran deficits almost 80% of the time.

How? Because those deficits were small and the economy grew like a weed. Even though debt didn't fall, its relevance did.

The example is a powerful reminder of a unique trait of government debt: As long as nominal GDP growth is higher than the annual deficit, a government can run in the red forever while actually lowering the burden of its debt. Indeed, the federal government has run a deficit in 82 of the last 112 years. It will probably do the same going forward.

Demographics will likely make economic growth harder to come by over the next 30 years than it was in the years after World War II. But we will likely deal with our $16 trillion debt in the same manner the country did after the war: by growing the economy faster than annual deficits.

The good news is that the vast majority of the trillion-dollar deficits run from 2009 to 2012 were direct consequences of the financial crisis and lingering recession. As the economy heals, spending on things like unemployment benefits will fall while tax revenue will rise, shrinking deficits back to a level below GDP growth and lowering the country's debt burden without actually paying debt off.

We're already seeing progress. The 2013 deficit is projected to be $642 billion, or 4% of GDP, down from more than 10% of GDP in 2009. That effectively stabilizes debt-to-GDP this year. The Congressional Budget Office now estimates that debt as a percent of GDP will be lower 10 years from now than it is today.

Back to the Museum of American Finance. "Alexander Hamilton said a national debt, if it is not excessive, will be a national blessing," David Cowen tells me.

Our debt does become excessive at times. Right now is probably one of those times. But the history of our national debt isn't about straight lines; it's about a roller coaster ride of debt binges to pay for the country's problems followed by long stretches of low deficits where debt as a percent of the economy shrinks. If history is any guide, we're much closer to the latter.

Seventy years from now, we may look back at the debt of the 2000s the same way we look at the debt of World War II: Wondering what we were all so worried about.

Keep reading to get a glimpse at some of our top stock recommendations.

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My name is Morgan Housel.

As a writer for The Motley Fool, I closely read the stock analysis of Motley Fool Co-founders David and Tom Gardner, who have run their flagship *Motley Fool Stock Advisor* newsletter for over 11 years now.

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But we both know that it takes more than just one or two stocks to get there.

After all, a stock is not a lottery ticket -- it's an ownership stake in a living, breathing business.

Which is why I want to send you a FREE copy of *Stocks 2013: The Investor's Guide to the Year Ahead* -- a brand-new premium report featuring 12 more timely stock recommendations.

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Motley Fool Co-founders David and Tom Gardner recently rounded up a team of our top equity analysts to identify those stocks that stand to profit most in the coming year...

After exhaustive research and number-crunching, they emerged with 12 companies, including...

- An insanely cheap Chinese housing developer. Its P/E ratio sits just above 1 and the cash on its balance sheet equals twice its market cap. Not to mention, it comes with a dividend yield just shy of 5%. When you look at just how massive a trend urban migration is in China, this investment looks like a no-brainer.

- The #2 supplier of sand in the United States. That's right – sand. Yet as boring as this investment may seem, sand is an essential component of fracking (a technique for extracting oil that's becoming increasingly more necessary.) Which is why demand has grown 28% annually since 2004. Thanks to its geographic and freight advantages, this company is perfectly positioned to quietly cash in on this growth.

- A currency play on the economic problems facing Japan. As the analyst who's recommending it put it, "the yen's strength against the dollar is an emperor with no kimono." Inflation is the only way out of the pickle Japan is in – which will crush the yen and send this investment skyrocketing.

You'll discover these three stocks, plus nine more powerful profit opportunities, the instant you download your FREE copy of *Stocks 2013: The Investor's Guide to the Year Ahead.*

Don't forget – this is the highly sought-after report that, year after year, has handed investors market-beating returns. Our top pick from last year has already shot up 48%, while the market rose just 19%.

And I'm confident several companies featured in this year's report could do the same – or better.

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Now obviously, the high-quality nature of this research and stock advice isn't something I can hand to just anyone.

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Discussion Boards -- Where else can you learn about a company directly from the candid experiences of the company's employees, customers, and investors? I don't know of any other newsletter or investment advisor or brokerage house that would welcome this type of frank exchange between its customers. But it's all part of the philosophy here at The Motley Fool.

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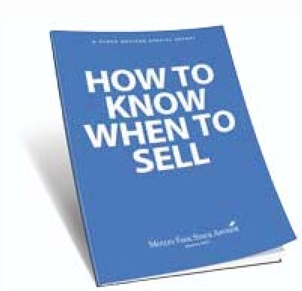

How to Know When to Sell – (a $29 value – YOURS FREE!) – David and Tom don't believe in selling before a company's fundamentals change dramatically (or you find an even better company). But it is necessary now and then. In this special report, "How to Know When to Sell," they reveal their simple, easy methods for quickly assessing your stocks, based on fundamentals.

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Get started!

All scorecard returns as of May 14, 2013. Unless otherwise noted, all numbers as of May 22, 2013. Motley Fool contributor Daniel Miller owns shares of Ford, General Motors, Westport Innovations.