Inquiring Minds

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The Federal Debt and What To Do About It

The federal debt is huge – about $22 trillion – and growing. The first paper sets out some of the problems this may create if Congress does not act to reduce the annual deficit and thereby prevent further increases or, miraculously, even reduce the debt. The second paper refutes several erroneous beliefs about the debt and ideas about dealing with it.

It should be noted that the problem of dealing with the deficit is made more difficult by the fact that more than two thirds of the federal budget is consumed by nondiscretionary programs (entitlement programs, including social security, health care, income security programs, etc.) that can only be changed by a change in the underlying law. The rest is in so-called discretionary programs, prominent among which is national defense (half of all discretionary spending and about 15% of total spending). These can be changed in the budgetary process without changing the underlying legislation. The table at the end of this paper shows selected items in this category.

Questions to consider:

- Other nations have lived and are living with higher debt levels that we have (Japan, for example), and some commentators have suggested that our debt level is still manageable. Do you agree?
- The deficit can be cut by increasing taxes, decreasing spending, or some combination of the two. How do you think we should proceed? If spending cuts are the answer, what should be cut? If tax increases are the way to go, what kind of taxes (income taxes, wealth taxes, sales taxes, user fees, etc.) and who should bear them?
- Can the debt be reduced in any meaningful way without grabbing the third rail in American politics – entitlements? Is there any approach to this that could be feasible?
- Health care is a major political issue. Should fiscal neutrality be a necessary condition for the adoption of any plan for health care?
- What criteria should govern proposals for new programs? Should there be kind of pay-as-you-go criterion? A benefit-cost test? Is it possible to constrain Congress in any such way?
- Are there other ways to reduce the debt, short of defaulting? Any ideas?

The Fiscal and Economic Impact of the Debt

Peter G. Peterson Foundation - *May 2019*

A strong fiscal outlook is an essential foundation for a growing, thriving economy. Putting our nation on a sustainable fiscal path creates a positive environment for growth, opportunity, and prosperity. With a strong fiscal foundation, the nation will have increased access to capital, more resources for future public and private investments, improved consumer and business confidence, and a stronger safety net.

However, if we fail to act, the opposite is also true. If our long-term fiscal challenges remain unaddressed, our economic environment weakens as confidence suffers, access to capital is reduced, interest costs crowd out key investments in our future, the conditions for growth deteriorate, and our nation is put at greater risk of economic crisis. If our long-term fiscal imbalance is not addressed, our future economy will be diminished, with fewer economic opportunities for individuals and families, and less fiscal flexibility to respond to future crises.

The following summarizes several of the negative ramifications of our growing debt:

Reduced Public Investment. As the federal debt increases, the government will spend more of its budget on interest costs, increasingly crowding out public investments. Over the next 10 years, the Congressional Budget Office (CBO) estimates that interest costs will total $7 trillion under current law. In just under a decade, interest on the debt will be the third largest "program" in the federal budget — and it is on pace to become the single largest by 2048. Interest costs, however, are not investments in programs that build our future. Instead, they are largely about the past. And as more federal resources are diverted to interest payments, fewer will be available to invest in areas that are important to economic growth. Although interest rates are currently low, we can't expect that situation to last forever. As economic growth improves, interest rates are likely to rise, and the federal government's borrowing costs are projected to increase markedly. By 2048, CBO projects that interest costs alone could be more than twice what the federal government has historically spent on R&D, nondefense infrastructure, and education combined.

Reduced Private Investment. Federal borrowing competes for funds in the nation's capital markets, thereby raising interest rates and crowding out new investment in business equipment and structures. Entrepreneurs face a higher cost of capital, potentially stifling innovation and slowing the advancement of new breakthroughs that could improve our lives. At some point, investors might begin to doubt the government's ability to repay debt and could demand even higher interest rates, further raising the cost of borrowing for businesses and households. Over time, lower confidence and reduced investment would slow the growth of productivity and wages of American workers.

Fewer Economic Opportunities for Americans. Growing debt also has a direct, real world effect on the economic opportunities available to every American. Based on data provided by CBO in its report The Deficit Reductions Necessary to Meet Various Targets for Federal Debt, the real (inflation-adjusted) income for a 4-person family could be reduced by as much as $16,000, on average, by 2048 as a result of rising federal debt. That amount would represent a four percent loss of income, compared to incomes if the debt is stabilized.

In addition, the debt negatively impacts economic opportunity and social mobility because it crowds out investments that help Americans get ahead. Higher interest rates make it harder for families to buy homes, finance car payments, or pay for college. Fewer education and training opportunities would leave workers without the skills to keep up with the demands of a more technology-based, global economy. Faltering support for research and development would make it harder for American businesses to remain on the cutting edge of innovation, and would hurt wage growth in the U.S. Slower economic growth generally would also make our fiscal challenges even worse, as lower incomes lead to smaller tax collections and put the federal budget further out of balance. Vital safety net programs would come under even greater budgetary pressure, threatening support for those who need them most.

Reduced Fiscal Flexibility. High levels of debt also reduce our government's flexibility to respond to future emergencies, unanticipated challenges, wars, or recessions. Indeed, one reason why the United States was able to recover from the Great Recession more quickly than other countries was because our debt was fairly low — at 35 percent of GDP — before the financial crisis began. As a result, U.S. policymakers had considerable flexibility in addressing the crisis. If debt had been significantly higher at the start of the crisis – as it is now – it would have been difficult to respond. Similarly, the United States had the fiscal wherewithal to meet the considerable demands of fighting World War II because debt was relatively low before the war.

Five Myths about Federal Debt

William Gale - *The Brookings Institution*, May 2, 2019

Despite a strong economy, the U.S. budget deficit recently rose by nearly 40 percent year over year, largely because of the tax cuts passed in 2017 and the spending deal approved in 2018. Federal debt — the accumulation of past deficits — reached its highest level ever relative to the economy, with the exception of a few years around World War II. And that's before financial shortfalls for Social Security and Medicare occur and send debt to unprecedented levels. Some conservatives warn of a coming debt crisis, while leading liberal economists argue that we can ignore deficits and debt at this time. Several myths are muddling the discussion.

MYTH NO. 1: DEBT IS HARMLESS IF IT'S ISSUED IN A NATION'S OWN CURRENCY.

In 2015, Nobel laureate Paul Krugman wrote that "because [public] debt is money we owe to ourselves, it does not directly make the economy poorer (and paying it off doesn't make us richer)." Stephanie Kelton, a prominent advocate of modern monetary theory, says that "we should think of the government's spending as self-financing since it pays its bills by sending new money into the economy." In 2011, Warren Buffett said, "The United States is not going to have a debt crisis as long as we keep issuing our debts in our own currency."

Yet in a recent University of Chicago survey of prominent economists, not one agreed that a country that issues debt in its own currency does not have to worry about deficits. Future debt will stem largely from anemic revenue growth and increased expenditures on an aging population. The result will reduce future national saving — the sum of saving by the private and public sectors — and drag down future national

income. This could happen through higher interest rates, which choke off investment and reduce production and income. Or it could happen through greater borrowing from abroad, which would allow us to maintain production but siphon off increasing resources to debt payments. Estimates by the Congressional Budget Office and others indicate that these effects could be substantial. Politically, sustained deficits and rising long-term debt make it harder to garner support for new policies or to address the next recession, war or emergency.

MYTH NO. 2: LOW INTEREST RATES MEAN DEBT DOESN'T MATTER.

In a recent address to the American Economic Association, Olivier Blanchard, a former chief economist at the International Monetary Fund, said, "The signal sent by low [interest] rates is that not only debt may not have a substantial fiscal cost, but also that it may have limited welfare costs." In *Foreign Affairs*, Jason Furman and Lawrence H. Summers wrote that low rates mean "policymakers should reconsider the traditional fiscal approach that has often wrong-headedly limited worthwhile investments." Although these preeminent economists have been careful to qualify their statements, the popular discussion has sometimes jumped to the conclusion that low interest rates mean that deficits don't matter.

Low interest rates certainly make debt more palatable and make the crisis scenarios look silly, but they are not a panacea. Under current law, the Congressional Budget Office projects that federal debt will rise from about 78 percent of gross domestic product (GDP) now to more than 150 percent by 2048 and will continue to increase afterward. Net interest payments are projected to rise from about 1.8 percent of GDP to more than 6 percent, which would be larger than the entire Social Security program.

Financial markets imply that low rates will persist, but have been wrong at times in the past. We can borrow and consume more if interest rates stay low forever, but if we accumulate a lot of debt and then rates rise, we will face major problems.

MYTH NO. 3: WE SHOULD BALANCE THE BUDGET AND PAY OFF THE DEBT.

Centrist and conservative politicians and pundits constantly seek a balanced federal budget. Former senator Orrin G. Hatch (R-Utah) was called "Mr. Balanced Budget" because he sponsored or cosponsored legislation related to that goal more than 25 times . In 2018, columnist George Will wrote an op-ed for The Washington Post titled, "America needs a balanced-budget amendment."

Balanced budgets may have symbolic value, but they are not necessary. Rules aimed at forcing balanced budgets make recessions deeper and longer by requiring spending cuts or tax increases during hard times, and they can be manipulated through accounting gimmicks. Almost every state has a balanced-budget rule, but many of them face future fiscal shortfalls focused on health-care and retirement spending, just as the federal government does.

An even more extreme goal is to pay off the entire debt. In 2016, Donald Trump said, "We've got to get rid of the $19 trillion in debt. . . . I think I could do it fairly quickly." But paying off all debt makes no sense. As Alexander Hamilton explained, debt can be a blessing: It can facilitate trade, finance national defense, fight

recessions, fund investments, and provide liquid and safe assets for investors. What we really need to do is put the debt on a stable and sustainable path. That will be hard enough.

MYTH NO. 4: WE CAN GROW OUR WAY OUT OF THE DEBT.

The Trump administration's most recent budget projects average annual growth rates of 2.9 percent over the next decade, a reduction of the debt to 71 percent of GDP by 2029 and a balanced budget within 15 years, as a result of greater tax revenue.

Those figures, however, seem implausible. The CBO, the Federal Reserve and the Blue Chip forecasters all predict annual growth at 2 percent or below after this year, largely because of slowing labor force expansion. Using more realistic projections, the administration's budget would actually yield a rising debt-to-GDP ratio. Faster economic growth could help lower debt, but the CBO estimates that raising productivity growth rates by one-third — an enormous boost — would slow the increase in the debt-to-GDP ratio over 30 years by only one-third.

In 1981, President Ronald Reagan's tax cuts and defense spending put the nation on a rising debt path that took numerous bipartisan budget deals over 15 years to reverse. But now the debt-to-GDP ratio is three times as large as it was in 1981, and demographics are working against us: Baby boomers were entering the labor force and buying homes in the 1980s and 1990s, but they are retiring now, which will increase spending on Social Security and Medicare. Without policy changes, the budget won't be able to avoid rising deficits and debt.

MYTH NO. 5: THERE'S AN EASY SOLUTION TO THE DEBT.

In his 2012 presidential campaign, Mitt Romney implied that he could tackle the debt in part by ending public television subsidies: "I like PBS. I love Big Bird. . . . But I'm not going to keep on spending money on things to borrow money from China to pay for it." Much of the public has similar sentiments. As one voter told lawmakers in 2013, "Get rid of the deductions that don't affect me."

Any serious plan to lower the debt must involve significant tax increases and/or major spending cuts. Foreign aid, government salaries and other programs that politicians typically target are tiny and eliminating them would not make much difference. Almost 70 percent of federal spending goes to Social Security, health care, defense and interest on the debt. Spending cuts will have to come from those areas. We can't unilaterally cut interest payments — that's called defaulting. And the other programs are extremely popular.

A second seemingly painless approach is to inflate away the debt. Trump once suggested to adviser Gary Cohn that the nation should "just run the presses — print money" to pay off the debt. This, of course, would lead to inflation. But most of our long-term obligations already are indexed to inflation, such as Social Security, Medicare and Medicaid payments. Inflation will not cut those costs.

The ultimate in pain-free solutions is the notion that broad-based tax cuts raise revenue. "Not only will this tax plan pay for itself, but it will pay down debt," Treasury Secretary Steven Mnuchin said in 2017. But the record very clearly shows that broad tax cuts — such as those passed in 2017 — reduce revenue.

Federal Discretionary Spending, FY 2018

	Billions of dollars
Defense, total	622.8
Nondefense, total	628.9
International affairs	50.4
Science, space and technology	31.4
Natural resources & environment	35.8
Agriculture	6.1
Transportation	92.0
Community & regional development	35.7
Education, training & social services	93.0
Health (non-Medicare)	61.3
Income security	69.5
Veterans benefits & services	72.9
Administration of justice	55.6

Source: Congressional Budget Office