How Will the Increasing National Debt Affect the Future of the U S Economy?

When discussing our nation's financial well-being the distinction between budgetary **deficits** and the amount of **debt** the government issues is important. The deficit is the difference between the Government's receipts and expenditures. Receipts include income, excise and social insurance taxes as well as fees and other income. Expenditures include all Federal spending, including Social Security and Medicare benefits and interest payments on the debt. When there is a budget deficit, the Treasury must borrow the difference. The deficit is a measure of a single year's shortfall, the difference between what the government takes in and what it spends.

To finance the deficit the Treasury sells securities such as Treasury bills, notes and bonds. Government Trust Funds are required by law to invest accumulated surpluses in Treasury securities. The Treasury securities sold to investors and bought by the Government Trust Funds then become part of the total debt.

Currently, the best estimate of the national **debt** over the next 10 years is that it will rise by $8.6 trillion. In recent years, however, the federal **deficit** has been going down thanks to the end of the recession (larger receipts) and a slower increase in government spending.

The Congressional Budget Office warns, however, that shrinking deficits won't last if the nation keeps to its current spending and taxing policies. Deficits will begin to increase in years to come, and continue increasing for the next 25 years, through 2038. According to the CBO's latest report, Social Security and Medicare expenditures will drive much of that deficit spending.

However, the U.S. is not like you or me. The U.S. Government has the power to tax the largest economy in the world, the power to print money and has an infinite life expectancy. All of these factors mean the federal government can incur large amounts of debt. Unlike loans incurred by individuals, in essence this debt need never be paid back. The British government has been running a sizable public debt since the Napoleonic Wars.

The U.S. can simply "roll over" its debt year after year. The US Treasury can issue new securities to pay off old ones. This is not a problem as long as investors are willing to hold U.S. Treasury securities. U.S. Treasury securities are popular due to their liquidity (they are easily converted to cash), their low risk (they have zero default risk because they are backed by "the full faith and credit" of the U.S. government), and certain tax advantages. Of course there may be some level beyond which the government might lack the ability to pay interest on the debt, but that level depends entirely on the government's ability to raise sufficient revenue without constraining economic activity.

U.S. citizens or agencies of the U.S. government own most of the debt. For the most part we are just paying interest to ourselves. Foreign interests own about 34% of the debt, and this proportion has remained virtually unchanged since 1980. Foreigners typically reinvest dollars from maturing issues and their interest payments in the U.S.

There are, however two aspects of our national debt that worry some people:

1. ***The interest payments on the debt redistribute income from taxpayers to bondholders***. This redistribution is potentially regressive because privately owned Treasury securities are held mainly by wealthier households. So all taxpayers pay debt interest, but mostly wealthier taxpayers receive that interest. However, higher income households also bear a larger tax burden than low- and middle-income households: In 1999 the top 1% of household in terms of income paid over 30% of all income taxes.
2. ***Increasing debts may produce a crowding out effect***. Increasing debt levels by the U.S. government raise the demand for loanable funds, which with full employment can raise interest rates and reduce the amount of private borrowing for investment spending. Thus government spending is said to "crowd out" private spending. The size of this effect is a subject of debate among economists and most likely depends critically on the state of the economy. In an economy operating significantly below capacity, crowding out is unlikely to occur because resources are available to be used by both the government and private investors.

Sources: http://www.oswego.edu/~edunne/debtmyths.html; Paul Krugman NYT; http://useconomy.about.com/

Prepared by the CIC Research Committee for the September 2015 meeting

The true measure of government debt is the ratio of debt to the size of the economy. At the right is a list of selected developed countries and the ratio of their public debt to GDP. There is disagreement on how to best measure this ratio, but these values can be used for relative comparisons. Of particular interest is Japan, which far outstrips all other developed countries in terms of the relative size of their debt.

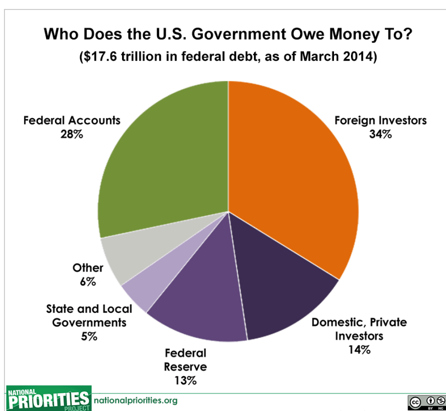
Country	Debt/GDP
Japan	230.0
Greece	177.1
Italy	132.1
Portugal	130.2
Ireland	109.7
Belgium	106.5
United States	103.0
Singapore	99.3
Spain	97.7
France	95.0
United Kingdom	89.4
Canada	86.5
Austria	84.5
Germany	74.7
Netherlands	68.8
Denmark	45.2
Sweden	43.9
China	41.1

The graphic below shows the trend in the Debt/GDP ratio since 1950.

After a decline in the ratio from 1996 to 2001, debt rose steadily as the US fought two unfunded wars. From 2008 on, the sharply rising ratio reflects the impact of the recession following the financial meltdown in 2007. Receipts fell sharply just as income supplements related to the recession rose. However, from 2013, the increase in the debt/GDP ratio has virtually stopped due to slightly increased taxes and rising receipts as the economy recovered. Clearly, the size of the debt relative to GDP is increasing much more slowly than in recent years. However, two questions concern many people: (1) is the size of the debt dangerous and (2) does who owns the debt matter?

In 1996, Alan Greenspan, chairman of the Federal Reserve Board, worried that the level of debt was getting too low to allow the Fed to carry out its monetary policy. A growing number of people--including Narayana Kocherlakota, the departing president of the Minneapolis Fed-- make the case that we need more, not less, government debt.

Issuing debt is a way to pay for the government to pay for useful things. The United States suffers from deficiencies in roads, rails, water systems and more; meanwhile the government can borrow at historically low interest rates. Beyond that, those very low interest rates are telling us something about what markets want. Having at least some government debt outstanding helps the economy function better. According to economists at MIT and others, the debt of stable, reliable governments provides “safe assets” that help investors manage risks, make transactions easier and avoid a destructive scramble for cash.”



The chart at left shows the ownership of US public debt. Of foreign investors, the government of China and Chinese private investors own about 8% and Japanese investors slightly less. The UK is the third largest holder. Domestically, Federal trust funds (mainly Social Security) and the Federal Reserve dominate. Many people worry about foreign ownership, but it’s hard to see why. On August 9, China reduced its holdings by about $180 billion and the market barely reacted. Benchmark 10-year yields **fell** 0.6 percentage point even though China also pared its stake between March 2014 and May of this year, based on the most recent data available from the Treasury Department. That’s not the doomsday scenario portrayed by those who said the size of the holdings--which peaked at $1.65 trillion in 2014 -- would leave the U.S. vulnerable to China’s whims.

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