Joint Economic Committee Democrats

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We'll Be Forever in Their Debt: The Economic Consequences of Irresponsible Budget Policy

The federal government and the U.S. economy face a looming debt crisis. The budget procedures and commitment to fiscal discipline that helped bring down the federal budget deficit and boost national saving in the 1990s have been abandoned. Deficits and debt are rising once again, as they were in the 1980s, and national saving has declined sharply.

Without a serious commitment to the budget principles and procedures that worked to restore fiscal discipline in the 1990s, the U.S. economy faces consequences likely to include growth-stunting increases in interest rates and possibly an international financial crisis. Symbolic gestures such as a line-item veto or unrealistic budget targets will almost surely fail again as they failed in the 1980s.

Overview

The U.S. debt crisis has both a domestic and an international dimension. Domestically, the credibility built up by fiscal discipline in the 1990s has been squandered, and large structural budget deficits have re-emerged at a time when the imminent retirement of the baby-boom generation will put enormous additional pressure on the federal budget. Internationally, both the United States government and the U.S. economy generally have been living beyond their means and relying on a mounting foreign debt to pay for those excesses.

Large federal budget deficits are a drain on national saving that will discourage economic growth and limit improvements in living standards. Interest rate increases have been moderated in recent years by the willingness of foreigners to channel their savings to the United States and hold U.S. IOUs. However, the current large payments imbalance between the United States and its trading partners is not sustainable, and growth financed by foreign borrowing rather than U.S. saving contributes little to boosting future U.S. living standards.

Who Holds the Debt?

Public holders of the federal debt include U.S. individuals and businesses; the Federal Reserve (which uses purchases and sales of Treasury securities as its main instrument of monetary policy); and foreign individuals, businesses, and governments (**Table 1**). According to U.S. Treasury data, debt held by the public increased by $1.4 trillion (41 percent) from January 2001 to April 2006. The doubling of foreign holdings of U.S. Treasury securities from $1.0 trillion to $2.1 trillion accounted for a large percentage of that 2001-2006 increase.

The total amount of federal debt outstanding (approximately $8.4 trillion) is larger than the debt held by the public (about $4.8 trillion) because total debt includes debt held by the Social Security Trust Fund and other government accounts. Total, or gross, debt was $5.7 trillion in January 2001. Since then, the buildup of assets in the Social Security Trust Fund and other government accounts has added about $1.2 trillion to the debt held in government accounts in addition to the $1.4 trillion that financing budget deficits has added to the debt held by the public.

The unified budget deficit and the debt held by the public are the best measures of the effects of government debt on financial markets and the economy because they net out debt and interest owed by one part of the government to another. However, the fact that gross debt has increased by substantially more than the debt held by the public is symptomatic of large deficits in the non-Social Security part

Table 1

Ownership of the Federal Debt

	April 2006	January 2001	Change
Total federal debt		(Trillions of dollars)	
Held by the public			
Federal Reserve	0.7	0.6	0.2
Other domestic holdings	2.0	1.8	0.2
Foreign holdings	2.1	1.0	1.1
Total debt held by the public	**4.8**	**3.4**	**1.4**
Held by government accounts	3.5	2.3	1.2
Total (gross) federal debt	**8.4**	**5.7**	**2.7**
Memorandum: Foreign holdings of U.S. Debt		(Billions of dollars)	
Japan	639.2	312.3	326.9
China	323.2	61.5	261.7
United Kingdom	166.8	47.8	119.0
OPEC	99.1	48.5	50.6
Korea	70.9	28.4	42.5
Taiwan	68.9	34.5	34.4
Caribbean banking centers	61.0	24.9	36.1
Hong Kong	49.4	39.1	10.3
Germany	46.8	48.0	-1.2
Others	540.6	365.8	174.8
Total	2065.9	1010.8	1055.1

Source: United States Department of the Treasury

Note: Items may not sum to total due to rounding

of the budget that have been masked by surpluses in Social Security. Using the accumulation of assets in the Social Security trust fund to finance other government spending rather than to pay down the debt held by the public undermines the purpose of the trust fund, which is to save in advance of the retirement of the baby boom generation.

Trends in Federal Deficits and Debt

The decade of the 1990s saw a remarkable turnaround in the fiscal condition of the United States. Federal debt held by the public, which had been on an upward trend following the Reagan tax cuts and the deep 1981-82 recession, peaked at 49.4 percent of gross domestic product (GDP) in 1993 (**Chart 1**). As budget deficits shrank over the rest of the decade and turned into surpluses, the federal debt fell as a percentage of GDP to 33.0 percent in 2001.

Most budget experts believe that budget process reforms in 1990 and 1993 contributed to this turnaround. The Gramm-Rudman-Hollings budget targets of the 1980s were abandoned, and meaningful but achievable caps on discretionary spending were instituted. Equally important, Congress established pay-as-you-go (paygo) rules for entitlements, other mandatory spending, and, importantly, taxes. Paygo rules required that proposals for tax cuts or increases in mandatory spending be offset by other policies that would keep the budget deficit from increasing.

When President Bush took office in January 2001, the Congressional Budget Office (CBO) was projecting a cumulative 10-year budget surplus of $5.6 trillion for fiscal years 2002 to 2011. CBO projected that debt held by the public would decline to less than 10 percent of GDP by 2006 and that the federal government would be a net creditor rather than a net debtor by the end of the decade.

Chart 1

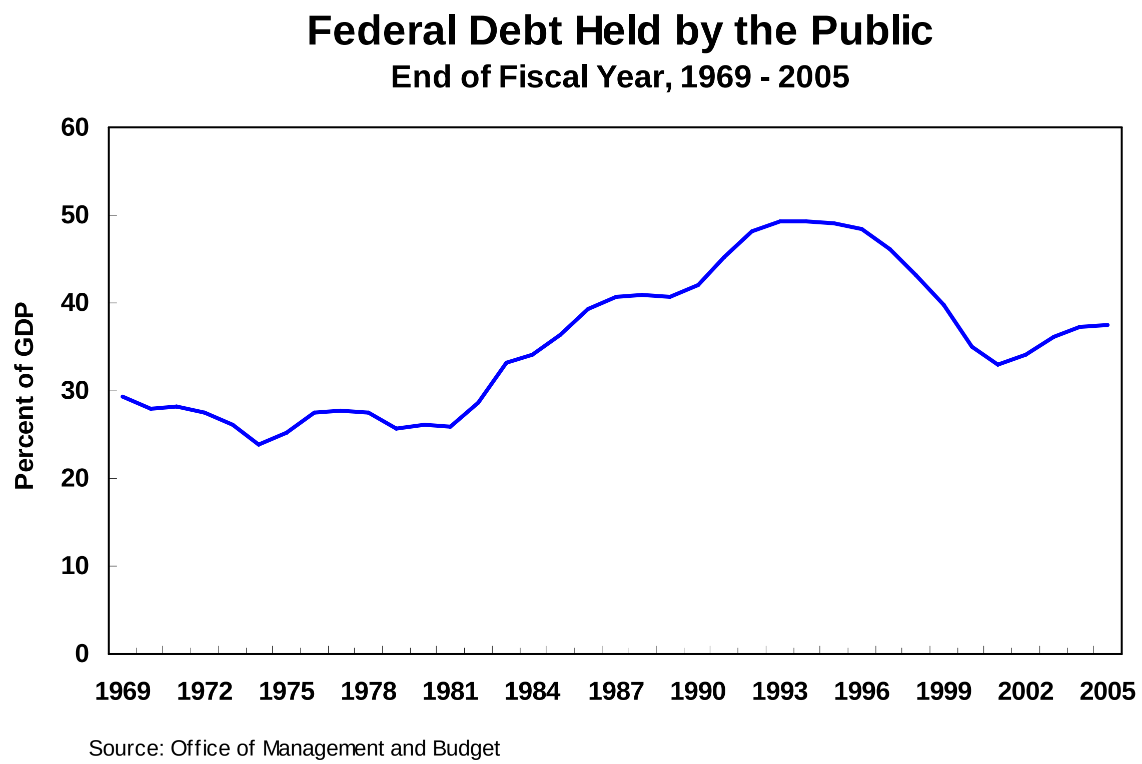
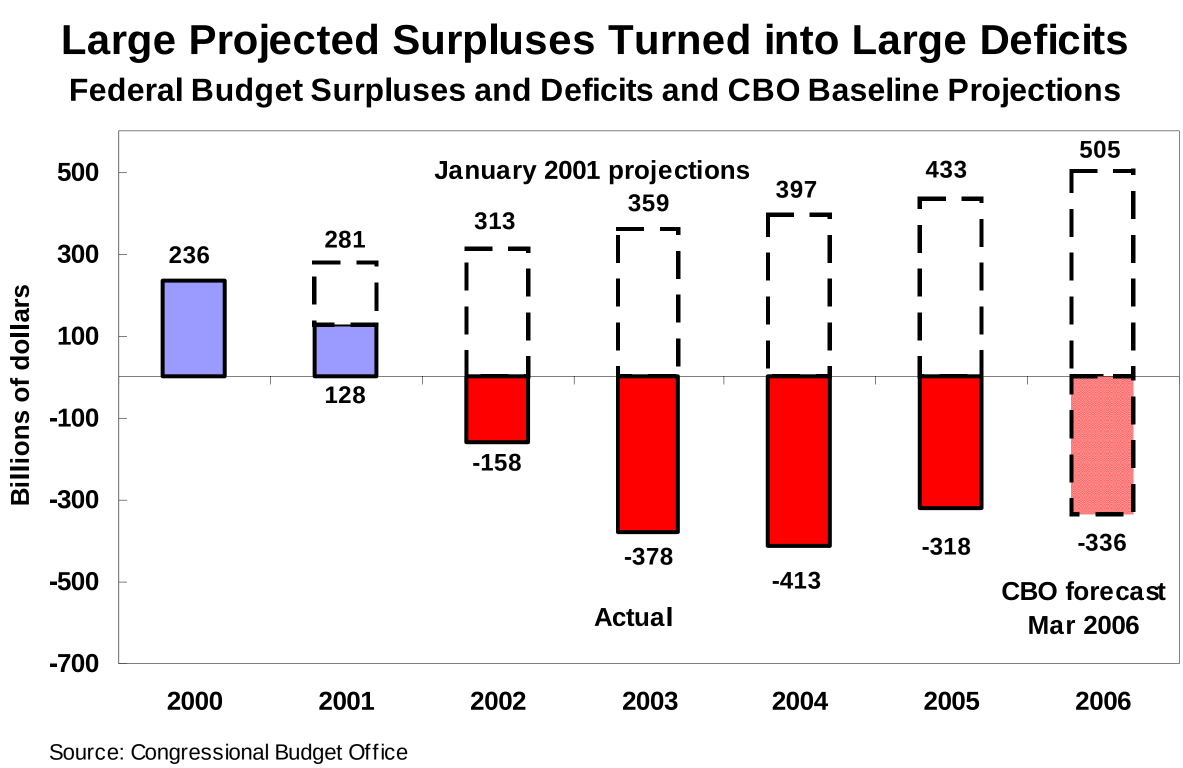


Chart 2



That changed with the Bush tax cuts, the recession of 2001, and increases in war-related and other government spending. Congress allowed budget caps and paygo rules to lapse, and the budget reconciliation procedure was used to facilitate deficit-increasing tax cuts rather than for its original purpose of enforcing budget discipline. Projected surpluses turned into actual deficits (**Chart 2**), and debt held by the public began to rise as a share of GDP.

Structural Budget Deficits Are What Matter

Budget deficits have a cyclical and a structural component. The cyclical component arises from fluctuations in the level of economic activity and unemployment over the business cycle. The structural component arises from policy decisions that determine the trend level of government revenues and expenditures over the longer term.

The budget deficit naturally fluctuates over the business cycle, widening in a recession and narrowing again as the economy recovers. Policy actions to counter the effects of a recession (such as temporary tax cuts or extending unemployment benefits) can also produce a temporary increase in the budget deficit. Cyclical deficits like those cushion the effects of recessions and are generally not harmful to the economy.

Persistent large budget deficits, in contrast, are bad for the economy because they reduce national saving, put upward pressure on interest rates, and discourage economic growth. Deficits that persist over the business cycle force the Federal Reserve to raise interest rates higher than they otherwise would be in order to keep the economy from overheating from the fiscal stimulus. Those higher interest rates depress investment and lower the economy's growth potential in the longer term.

Borrowing from Abroad Is Not the Answer

This traditional analysis of how budget deficits raise interest rates and discourage long-term growth recognizes that U.S. national investment has to be financed largely with U.S. national saving over the long run. Budget deficits reduce government saving, and unless they are completely offset by an increase in private saving, national saving will fall as well. With less national saving, national investment has to fall, with higher interest rates being part of the adjustment process.

In today's open international economy, borrowing from abroad can finance a gap between national saving and national investment, at least for a time. Instead of the Fed having to raise interest rates to offset the stimulus from persistent large budget deficits, the excess spending can spill over to imports without putting inflationary pressure on U.S. productive capacity. But in order for U.S. spending to exceed U.S. income, the rest of the world has to be willing to lend to the United States or buy U.S. assets. Honoring a mounting international debt will require future payments out of U.S. national income that will depress U.S. living standards.

The current account deficit is the measure of how much the United States borrows from the rest of the world each year to finance its current payments imbalances (largely the trade deficit in goods and services). In 2005, the current account deficit was nearly $800 billion or 6.3 percent of GDP. The net international investment position of the United States measures the difference between U.S. net claims on the rest of the world and net claims on the United States by the rest of the world. In 2004, the United States net debt to the rest of the world was $2.5 trillion, and the figure for 2005 could be as much as $1 trillion higher.

There is widespread agreement that a large U.S. current account deficit is unsustainable and that U.S. saving and investment will have to move closer together as part of the adjustment process. A substantial depreciation of the dollar is almost inevitable. There is considerable disagreement, however, about when or how these adjustments will take place.

If the rest of the world decides that the advantages of holding U.S. Treasury securities and other dollar-denominated assets are no longer worth the risk of significant capital losses from a depreciation of the dollar, there could be a flight from the dollar and possibly an international financial crisis. But even if the adjustment is more orderly, the adjustment will result in a sharp reduction in U.S. investment that will be detrimental to long-term growth and future living standards unless the United States restores fiscal discipline and boosts national saving substantially.

The Economy Is Growing, So What Is the Problem?

A growing federal debt and growing international indebtedness are signs of the looming debt crisis. However, a sense of complacency may have set in because many of the predicted consequences of rising debt and the abandonment of fiscal discipline are not yet evident in the performance of the economy. So far, the main adverse consequence has been the sharp decline in national saving, which has not had much of an effect on the economy in the short run but will depress living standards in the future.

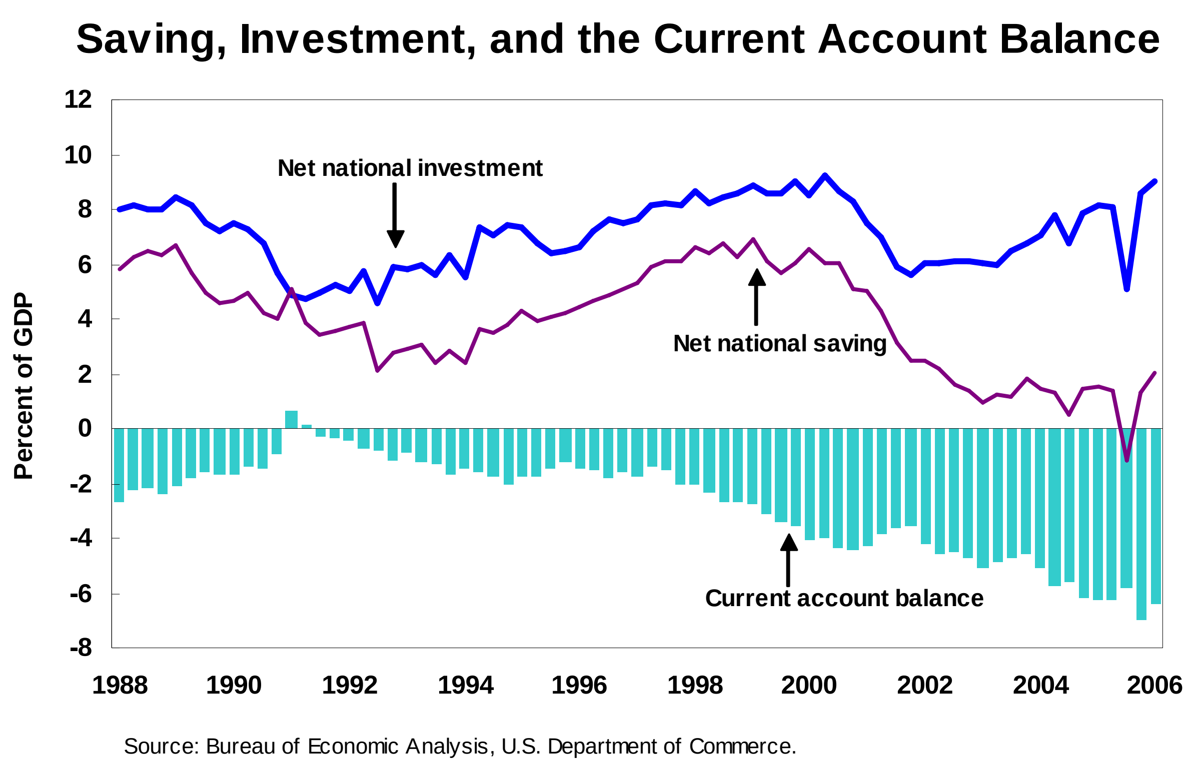
To be sure, the U.S. economy has experienced a business cycle recovery since the recession of 2001 and there has been a cyclical improvement in the budget deficit. However, the argument about the adverse consequences of budget deficits is about the harm from embedded structural budget deficits, and they persist.

In fact, the tax cuts that the Administration and its supporters are touting as an important contributor to the recovery were poorly designed to provide job-creating stimulus in the short run, while they have added to the structural budget deficit in the long run. The recovery owes more to the natural resiliency of the U.S. economy and the policies of the Federal Reserve than it does to those tax cuts.

There is no rigid relationship between the budget deficit and the trade deficit. In fact, the current account deficit began to widen in the 1990s when the economy was strong and fiscal discipline was turning the budget from deficit to surplus (**Chart 3**). However, the effect of the budget on national saving does matter, and the relationship between saving and investment and the sources of the current account deficit were quite different in the 1990s from what they are now.

The fiscal discipline of the 1990s contributed to strong growth in U.S. net national saving. However, investment growth was so strong that investment continued to exceed national saving, and the difference was financed by international capital flows. A current account deficit was the inevitable byproduct. Nevertheless, an increasing fraction of U.S. investment was financed by U.S. saving, hence most of that investment contributed to growth that raised future living standards in the United States.

Chart 3



After 2000, in contrast, large federal budget deficits contributed to a sharp decline in net national saving. Net national investment did not collapse along with saving, but the fraction of that investment financed by international borrowing increased sharply. Investment financed by foreign borrowing contributes far less to raising future living standards in the United States than investment financed by U.S. national saving.

Conclusion

The fiscal discipline of the 1990s contributed to the longest economic expansion on record and allowed the Federal Reserve to maintain interest rates that were favorable to investment and long-term growth. That fiscal discipline was abandoned beginning with the 2001 tax cuts, and the legacy of fiscal discipline has been squandered. Federal government debt is growing again rather than shrinking, and U.S. borrowing from the rest of the world is expanding at an unsustainable pace. Unfortunately, the response of the Bush Administration and its Congressional allies has been to ignore the tools and policies of fiscal discipline that worked in the 1990s and to focus on fig leaves like the line-item veto or a return to the unsuccessful budget rules tried in the 1980s.