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Federal Debt: The Good, the Bad, and the Ugly

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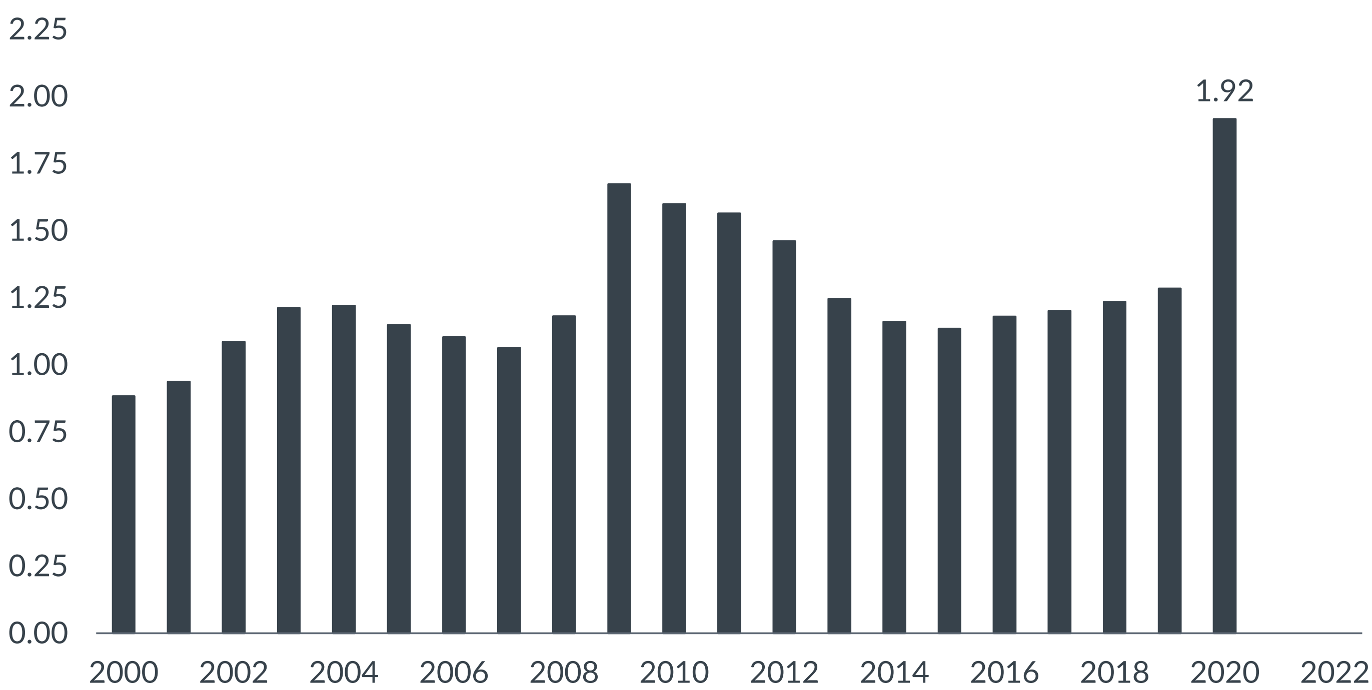
> "We are ruined, Sir, if we do not over-rule the principles that 'the more we owe, the more prosperous we shall be.'"
>
> -Thomas Jefferson, an ardent deficit hawk, in a letter to James Monroe

Summary

For the past century, the federal government has had an annual budget deficit for 96 of those years. For the past 10 fiscal years alone, almost all during an economic expansion, the federal government spent an average of $1.34 for each dollar in tax revenue it brought in (see Figure 1). Since the start of the recession in February, the federal government spent $1.91 for each dollar of income. For a household budget, that is not sustainable; but it is possible for it to work for a federal/ national government. Yet, is it desirable? The rapidly growing debt is a topic that frustrates voters, but at the same time, voters have not yet sought to elect leaders who are focused on balancing our government's budget. This issue has not been a major presidential election topic since Ross Perot ran for president in 1992. This paper will explore the many complicated issues surrounding the federal debt.

FIGURE 1

Federal Government Spending
Ratio of Each Dollar of Spending Relative to Each Dollar of Income, fiscal year ($)



Source: U.S. Treasury as of 2019.

Introduction

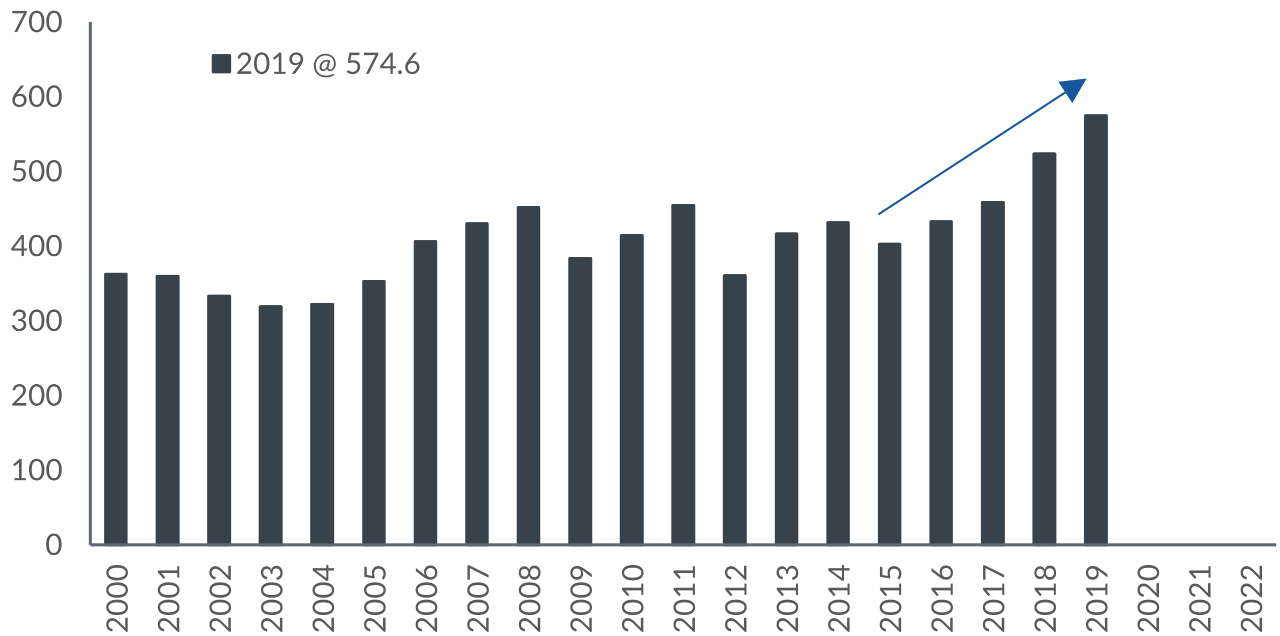
Should the federal government run budget deficits or balance its budget? This is a question that many economists often do not agree on. Some believe budget deficits are appropriate under certain circumstances, but other economists believe achieving regular balanced budgets is best. The decision to balance a federal budget or run a budget deficit has complicated repercussions that can impact an economy for decades. So far, the deficits have not had much of an adverse impact, which strengthens the views to continue operating ongoing deficits. Other economists warn that budget deficits can be harmful to the present and future economies. Nearly all economists agree that a government needs the flexibility in fiscal policy derived from running budget deficits to mitigate the downside risks of an economic contraction.

Balanced Federal Budget

Just like a household budget, a balanced federal budget offers many advantages. Most notably, without debt payments, tax revenue can be used solely for government services and/or lower tax rates. In 2019, the federal government spent $575 billion in interest payments, clearly a lot of money. The amount has been increasing for four straight years and will surely rise this year despite record low interest rates. Clearly, the increasing size of the deficit of the past few years is more than offsetting the savings from lower interest rates (see figure 2). Another advantage to balancing the budget is that the credit rating would be higher, which will be beneficial for lower borrowing costs and, in the event of a rainy day, the ability to borrow more without incurring an extra cost.

FIGURE 2

Interest on Treasury Debt Securities
$, billions, calendar year



Source: U.S. Treasury as of 2019.

There has always been concern that budget deficits could boost interest rates (supply outpacing demand). Furthermore, the higher yields could cause a diversion of private wealth toward the investment in government bonds and not private industry, which can be used to expand an economy. But, in reality, there is very little empirical data that links large budget deficits with increased interest rates and reduced investment. There may be, at some level of debt to GDP, a relationship between debt and interest rates, but there are many factors beyond just debt levels of a government that influence the interest rates.

Federal Budget Deficits and Keynesian Economics

History is full of famous quotes about the virtue of not having debt. But governments think very differently. Much of this has been influenced by famed British economist John Maynard Keynes, who published his seminal book, "The General Theory of Employment, Interest, and Money," in 1936. Since then, politicians have seized upon his theories that the government has the responsibility to push against the economy's tides by using both fiscal policy and monetary policy in the business cycle to mitigate economic downturns and rein in excessive growth.

Keynesian economics is considered a "demand-side" theory. In his book, Keynes focuses on the role that government intervention can play in managing an economic cycle's ups and downs. When the economy is slowing, the government can increase aggregate demand in the immediate term by lowering taxes, decreasing interest rates, and increasing social spending (enhanced unemployment insurance, food stamps, etc.). The critical component is the spending, which has a multiplier effect. The theory assumes that, for each dollar that the government spends, more than that dollar can increase economic output. For example, when that dollar is spent, a profit is realized, then that profit is spent again, and another profit is realized, and so on.

The move to Keynesian economics has resulted in running annual deficits as an acceptable policy for the government. What is less obvious is the degree of deficit spending. Justifying increased federal spending during downturns in the economy is a much agreed upon correct policy decision. The problem comes when the economy bounces back, probably due in part to an increase in government spending. The theory also states that the opposite is true for managing periods of economic prosperity. The government should spend less money, reduce spending and increase savings or pay down debt levels. Generally speaking, two of those three tend to happen consistently. Government spending tends to slow as the economy begins to accelerate, which is usually due to the economy generating sufficient growth and employment. Interest rates tend to increase, but they are managed by the central bank. The reduction in government spending is where the fiscally responsible government falls short, as it doesn't tend to decrease spending, increase savings or reduce deficits. It is hard for elected officials to be willing to cut federal spending. If the energized economy can grow faster than the debt, then the debt-to-GDP ratio declines.

Deficit vs. Debt

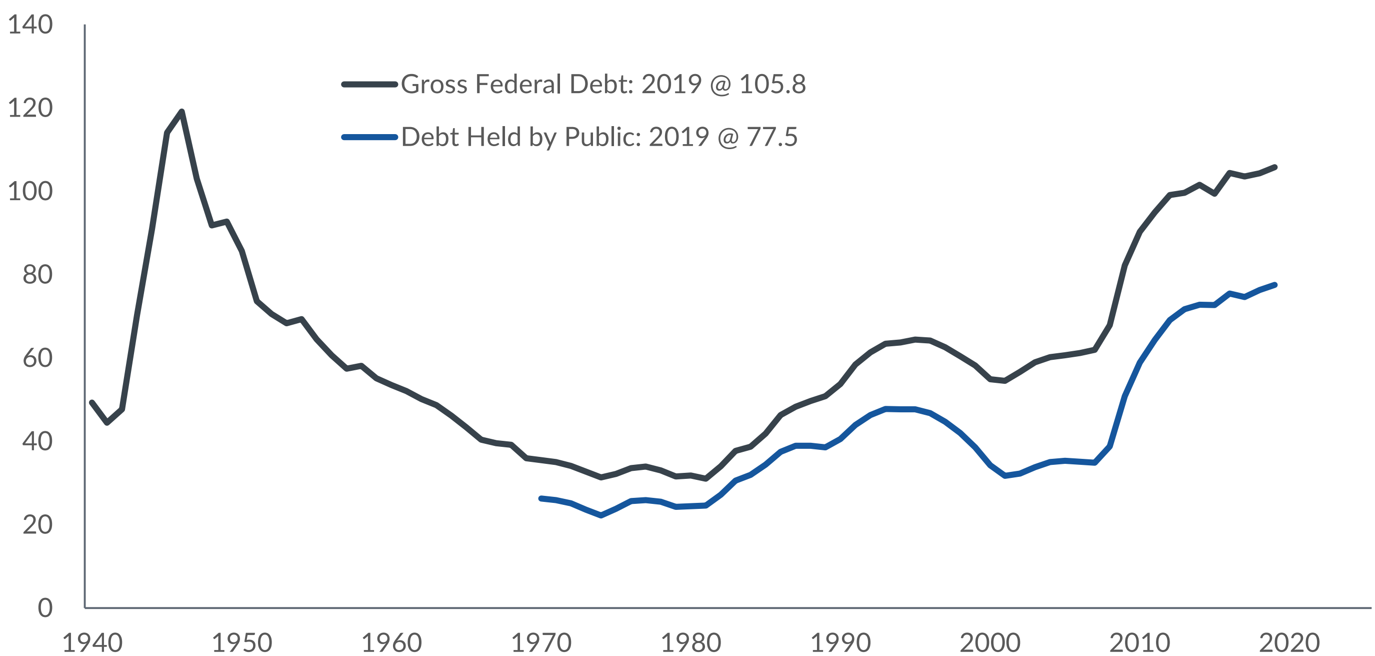
Economists don't tend to focus much attention on the annual deficit as being too excessive or not, since it can be altered relatively quickly. Instead, they focus their attention on the aggregate amount of all the outstanding deficits, referred to as the federal debt. Yes, the difference between the words "deficit" and "debt" is subtle; but it is also significant.

The federal debt currently stands at $20.3 trillion,* which is a large amount. To fairly make historical comparisons with this number, it is essential to compare it against the size of the economy (GDP). Historically, the aggregate debt was the total amount of all debt obligations, including what the government owed to itself (intragovernmental debt). But, in the 1970s, they started to use a new metric, "Debt Held by the Public to GDP," which is the sum of all debt held by entities outside the federal government that is traded in the public markets. It does not include the debt held by intragovernmental entities. The benefit of this decision is that it makes the ratio of debt to GDP smaller (see Figure 3). The timing was opportune; as the baby boomers were entering the job market and making payments into the Social Security Trust Fund, the revenues grew faster than the liabilities, sharply increasing the size of the Trust. As time moved on, the Trust Fund's growing balances made them the largest intragovernmental buyers of Treasury debt.

*Debt held by public, September 2020

FIGURE 3

Federal Debt as a Percent of GDP (%)



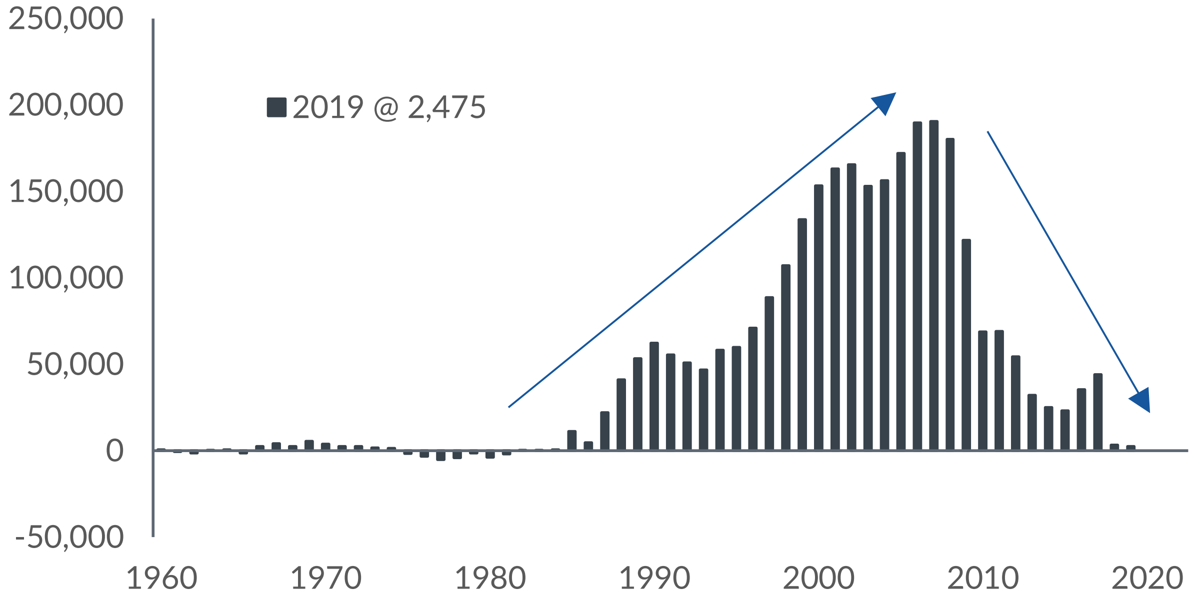
Source: U.S. Treasury as of 2019.

As the size of the Social Security Trust Fund grew, it helped to reduce the rate of growth of the debt held by the public as a percent of GDP. But times are changing; baby boomers are retiring and the rate of growth of the Trust Fund is falling (see Figure 4). In a few years, the Trust Fund size will start to decline as more baby boomers retire. But right now, it owns about $3.0 trillion of Treasury debt.

FIGURE 4

Social Security: Annual Net Increase

$, millions



Source: Social Security Administration as of 2019.

What is the better metric for measuring the level of debt? They both are essential for different reasons. Economists and central bankers favor the public debt to GDP since it provides better insight into understanding the stimulus the debt gives the economy or if it is causing a crowding out of the private investment. The gross debt is also significant since that is used to determine if the federal government is hitting its debt ceiling.

Reserve Currency

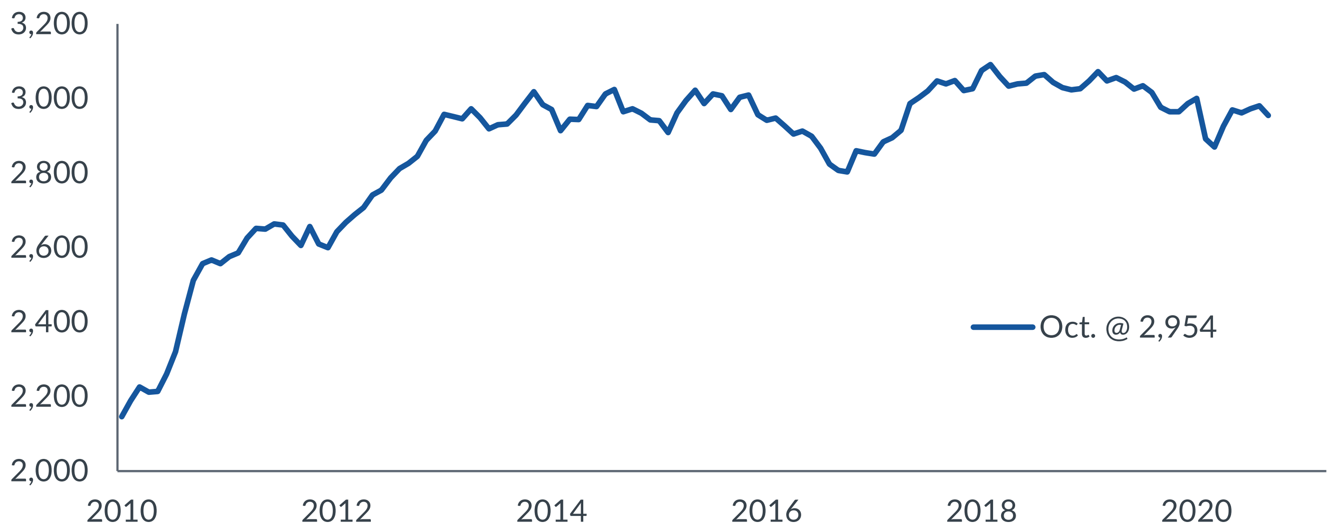
In addition to the Social Security Trust Fund being a large buyer of Treasury debt, there are also foreign central banks that own a large amount of Treasury debt. Ever since the Bretton Woods Agreement in 1944, the U.S. dollar has been crowned the world's reserve currency, replacing the U.K.'s pound sterling. It made sense. At the time, the U.S. economy was about 50% of the global economy and growth prospects looked good since the industrial complex had not been decimated by the war, like much of the rest of the industrialized world.

A reserve currency has a special status among currencies. It is used in international transactions, trade, investment, and debt obligations — for example, many global commodities like oil, trade in dollars. As a result, it is an anchor currency held in significant quantities by central banks around the world. The banks don't tend to own the currency because it does not produce any interest income. Instead, they buy U.S. Treasury bonds that do provide interest income. Those bonds can be quickly converted into cash by trading them in the market.

The U.S. dollar is not the only reserve currency. There are other reserve currencies today, but the U.S. dollar accounts for 61% of foreign bank reserves since these banks don't tend to own cash. The market for U.S. Treasury bonds is the largest and most liquid financial market in the world. Foreign central banks own about $3.0 trillion in U.S. Treasury debt (see Figure 5).

FIGURE 5

U.S. Treasury Securities Held in Custody
Foreign Official & International Accounts
$, millions, not seasonally adjusted



Source: U.S. Treasury as of October 2020.

How much debt is too much debt?

At what point is the level of accumulation of debt excessive? There is no simple answer.

Economists don't agree on what level of debt to GDP begins to have a negative impact on a national economy. Usually, though, the creditworthiness is what matters when considering what levels of debt a federal government can carry. At the present time, the record-low levels of interest rates on U.S. government debt seem to suggest that bondholders are not overly concerned about the creditworthiness of the U.S. government. In addition, as the chart shows, the interest expense on current debt levels as a percentage of GDP are lower than in the 1980s and 1990s (see Figure

9). Finally, credit confidence can change rather quickly. It is the confidence in the U.S. government that will be the ultimate determinant of what level of debt is excessive. One large government, Japan, has a debt to GDP ratio of 240% of GDP, which shows that the previously thought too high levels of GDP, causing interest rates to soar, is not correct. As for the future, investors will judge their confidence in a government based on many factors, and, so far, the U.S. government has been viewed as a strong economy with the ability to repay current debts. How much more U.S. government debt will investors accept, and, for how much longer will they accept it? Many smart economists will disagree on the particular level.

So, economic research has given no definitive answer to the question.

Debt Limit

The United States has a debt ceiling. It is a legislative limit on the amount of debt the Treasury can issue. Only the U.S. has one legislative act to authorize spending, and another to authorize payment for the expenditures. The law has been around since 1917, and it was put in place to ensure that too much money was not spent on WWI. Since then, it has turned into a political tool that is just a thorn in the side of the party of the majority. The debt ceiling has always increased when needed.

Fiat Currency

An argument is often made that the U.S. dollar has no hard asset backing, like gold, which has allowed for the creation of the massive amount of debt. The U.S. dollar, like all major currencies in the world, is a fiat currency. The currency has no backing of a physical commodity, such as gold and silver. Fiat money rose to prominence in the 1970s, with the collapse of the Bretton Woods Agreement, when the U.S. ceased to allow the conversion of the dollar into gold. Most other countries of the world followed suit.

By not being on the gold standard, the Fed is free to respond to economic changes by quickly increasing or decreasing the flow of money into the economy. Since the Great Depression (when the U.S. dollar was linked to the price of gold), the Fed has used this tool effectively and has been able to reduce the duration of recessions and extend the length of expansions.

But there are risks to a free-floating currency. It can succumb to global pressures. As Nobel laureate Paul Krugman wrote, "…a system that leaves monetary managers free to do good also leaves them free to be irresponsible — and, in some countries, they have been quick to take the opportunity." There have been some doozies, including Weimar Republic's mark in 1923, China's money in 1945, the Zimbabwean dollar in 1980-2009, and the Venezuelan bolivar, which began in 2016.

Fortunately for the United States, and many other industrialized countries, the central bank is independent and separate from political pressures.

Projections of Future Debt

The Congressional Budget Office, the bipartisan federal agency that provides Congress with economic and budgetary analyses, produces a semiannual report on the president's budget and the long-term (10-year) budget picture. They have been doing so since the 1990s. They also provide a set of options for reducing budget deficits.

It is the projection of future debt that is the most important. Many assumptions go into the calculation for their forecast, including the rate of economic growth, inflation, tax rates, productivity, level of interest rates, etc. As a result of the risk of a variance between assumed and actual outcomes, rarely are the projections accurate. That said, they do provide an important baseline of what is expected of the future.

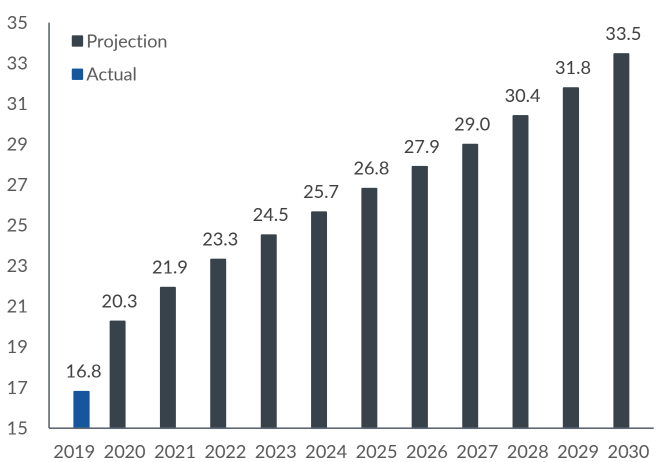
The U.S. debt is high by historical standards, in dollar terms. It is expected to continue rising due primarily to the aging of the population, which will require increased spending on healthcare, since per person health costs have been rising faster than inflation.

The below charts show their most up-to-date projections, which were published in September 2020.

FIGURE 6

CBO Baseline Projection of Federal Debt

$, trillions

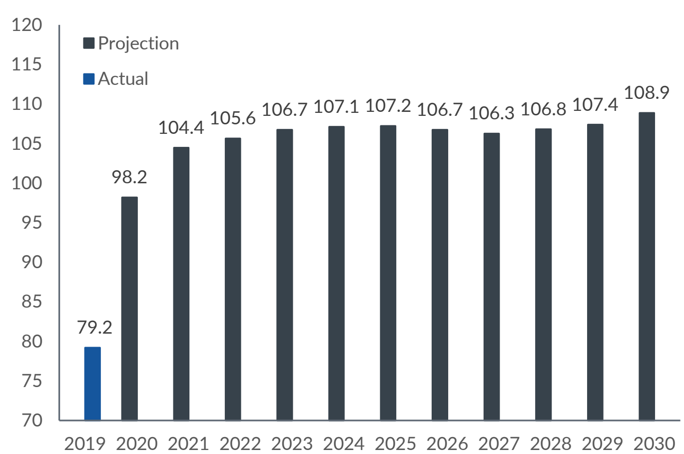


Source: Congressional Budget Office as of September 2020.

FIGURE 7

CBO Baseline Projection of Federal Debt

% of GDP



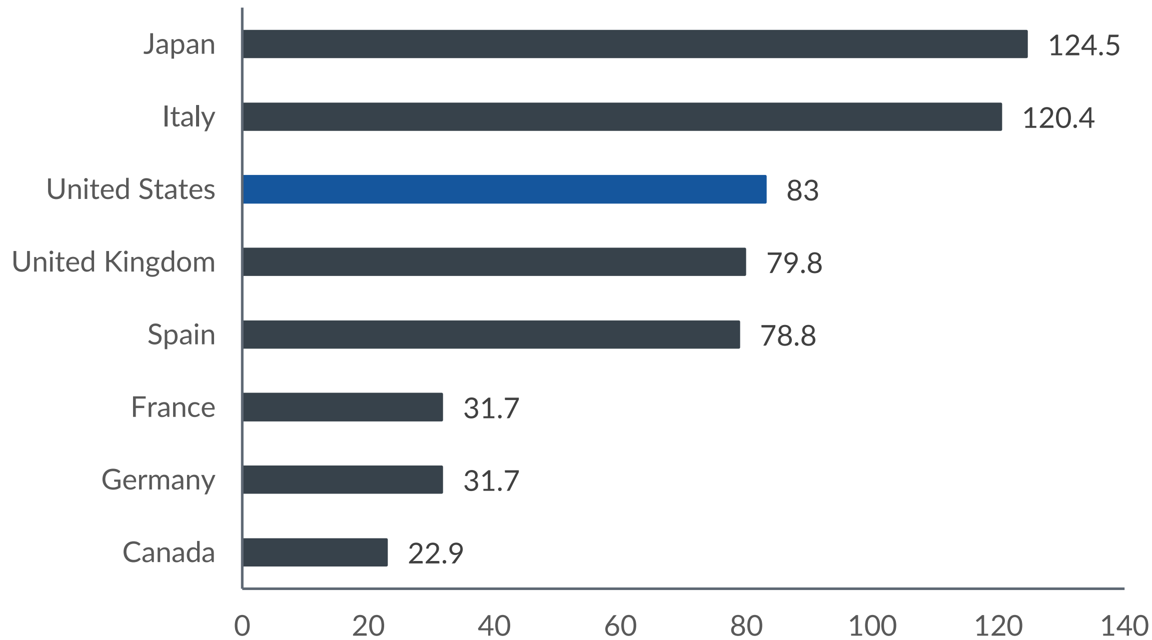
Source: Congressional Budget Office as of September 2020.

Government Debt to GDP Around the World

The United States is not the only country in the world that has growing national debt. It is growing globally, and that is raising alarm bells. Most industrialized countries are much like the United States, as they have fiat currencies and follow Keynesian economic policies. Yet, debt to GDP varies greatly among these countries. This provides risks that may be greater or lower than what the United States faces. For example, Japan has the highest level of debt relative to GDP. Its debt levels began to swell in the late 1990s, as their economy began to falter due to bubbles bursting in their equity and real estate markets following the Asian financial crisis that began in July 1997. But 90% of their debt is owned by Japanese investors, so there is very little risk of a flight of foreign investors.

FIGURE 8

Debt of Selected Countries
debt as a percent of GDP, 2018 YE, %



Source: Congressional Budget Office as of February 2020.

Interest on Debt

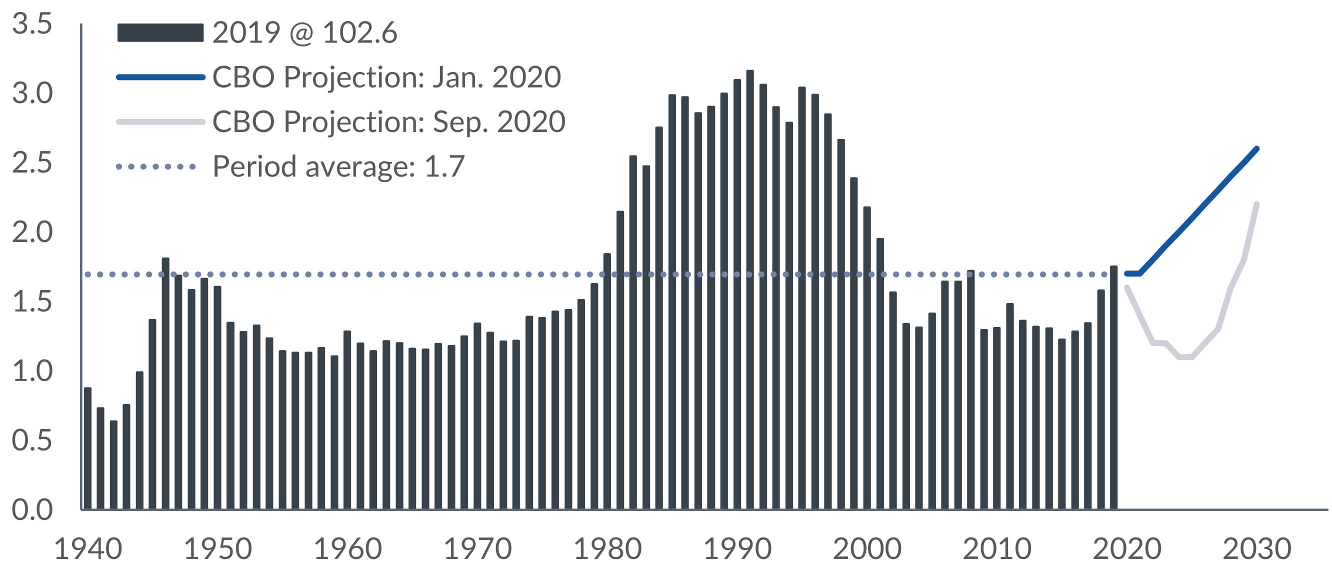
This is always a bugaboo of a topic. With the sharp rise in the deficit over the past few decades, the concern of many taxpayers is the interest cost. Since 2000, the average annual interest cost has been $409 billion per year.

This is another metric that needs to be measured against GDP to be put into proper historical standards. In the past three years, as the dollar value of the deficit has been growing, the debt-to-GDP has also been growing. It now stands at a level that is about equal to the long-term average.

What is fascinating is how the CBO's projections have changed since the pandemic. Back in January, the CBO thought it would grow to 2.6% over the next 10 years. But, in its September update, the CBO sees it declining over the next few years before resuming its upward trend. Despite the massive increase in the amount of government debt, lower interest rates and a strong rate of economic growth over the next few years (due to massive amounts of relief and stimuli) will lower the ratio.

FIGURE 9

Treasury Interest Payments
% of GDP



Source: Congressional Budget Office as of September 2020.

All this aggressive action by the Fed, along with the fiscal stimulus from the federal government, will significantly reduce the risk of the economy entering into stagnation, or even a double-dip recession. A double-dip recession is very rare in the United States; it has only happened once, back in 1980-81. Back then, the Volker Fed was aggressively raising interest rates to break the back of the very high level of inflation.

Current Status

The 2020 FY budget deficit was a shortfall of $3.1 trillion, more than three times the deficit of 2019 FY. This was brought on by federal spending increasing 47.3% (due to massive government spending to offset the downside risks from the coronavirus) and revenues declining 1.2%. The deficit stands at 16% of GDP, the largest level since 1945. For some perspective, at the worst of the financial crisis in 2009, it stood at 10% of GDP. The CBO expects the annual deficit to grow for the next few decades.

The economy has recovered faster than expected but still has a long way to go. More fiscal aid is needed. The amount of that aid will be based on what Congress and the White House will approve. Based on the recent election, there is a split government, which probably means the fiscal aid will not be as massive as it was once hoped. This, combined with recent good news on a coronavirus vaccine, may indicate that the deficit will return to the pre-pandemic trend.

Conclusion

It is clear that federal deficits enhance economic performance. What is not clear is what is, and what is not, an acceptable amount debt.

The ebbs and flows of the economic cycle require the amount of federal government stimulus to increase and decrease. It is politics in Washington that decides what that amount should be.

To date, the budget deficits have not been a political liability for many politicians. Until that happens, significant changes in the trajectory of the growing debt will not occur.