

# An Econo-Ed Group Paper: The National Debt

## **What is the National Debt?**

The National Debt is the accumulated budget deficits of the Federal Government. Budget deficits arise because the government spends more than the tax revenue it takes in during the October 1 to September 30 Fiscal Year (FY).

A budgetary imbalance and a budget deficit and the consequent National Debt are unavoidable and necessary. Nations often face unexpected calamities, such as natural disasters, wars, or economic recessions when tax revenues decrease. The assumption is that during economic booms, tax revenue will increase, creating a budget surplus. This will offset some of the borrowing a government has had to do. Thus, with careful budgetary planning and prudent borrowing, a fiscal balance can be maintained over time.

When, however, a nation lives beyond its means for a long period, the uncurbed accumulation of its National Debt is unsustainable, and endangers the nation's financial stability and economic growth, and its future will be threatened as a sovereign country.

Congress sets a limit—or ceiling—on the National Debt. This ceiling may be adjusted at any time during the fiscal year if more borrowing is necessary to meet required expenditures. The current ceiling has recently been raised to \$11.3 trillion, from the previous \$10.6 trillion, in order to support the additional borrowings necessary for restoring the financial stability and economic health threatened by sub-prime mortgage loan crisis.

The National Debt is “owned” (that is owed to and held) by intragovernment agencies such

as the Social Security Trust Fund, and by the public, including banks and other lending agencies, and by foreign central banks and their government agencies. Currently, a little more than 50 percent of such public debt is held by foreign nations, and this share has been growing in recent years, thus placing the U.S. at the top among the debtor nations.

The outstanding National Debt amounted to \$10.2 trillion as of October 7, 2008. This does not include any future obligations of the Federal Government, such as interest on the debt, or Social Security and Medicare payments.

## **Why does the National Debt matter?**

While a periodic budget deficit and additional National Debt may be necessary in order for governments to deal with unexpected events or to maintain their priority spending programs, it is important to consider some salient aspects of the debt which deeply concern many economists and experts.

**First:** The debt is a sovereign obligation which must be repaid. The size and continuing growth of the National Debt raise the high probability that the debt burden will have to be shifted to future generations. The debt is repaid either by generating more revenue, or by cutting expenditures, or both, or by doing more borrowing. The more the current generation relies on borrowing, the more future generations will have to repay.

**Second:** As the government continues to run budget deficits, its interest payment portion on the debt will increase as well, thereby squeezing other discretionary expenditures unless the government incurs additional borrowing. The current interest payment on the National Debt,

at nearly 11 percent of the total budget, accounts for about one third of the government's discretionary spending. This constrains the government's ability to spend on such critical programs as education, R&D, unemployment benefits, environment, and infrastructure maintenance.

**Third:** It is crucial for a nation to generate adequate rates of national saving for investment to support a reasonable rate of economic growth, with full employment and price stability. To this end, the European Union has set such budgetary restraint benchmarks as limiting annual budget deficits to 3 percent of GDP, and maintaining individual members' national debt to 60 percent of their GDP. When the National Debt rises above this level, government borrowing from the pool of a country's national savings would result in higher interest and hampered economic growth. In comparison, the U.S. budget deficit amounted to \$455 billion in FY 2007–8, ending on September 30. This was equivalent to slightly more than 3 percent of estimated GDP and an outstanding National Debt at about 70 percent. For FY 2008–9, the budget deficit is estimated at \$700 billion, equivalent to about 6 percent of GDP. The National Debt is therefore approaching 80 percent of GDP and both rates are expected to grow under the current financial and economic calamities.

**Fourth:** Because of the large budget deficit combined with a near zero rate of U.S. household savings, the government's deficit is increasingly financed in recent years by direct borrowing from the Federal Reserve Bank. Such borrowing is just printing money and is inflationary. It has also had to rely on borrowing from foreign nations, amounting to over one half of the federal government's public debt which is growing alarmingly large. Foreign buyers of Treasury securities are assumed to be operating on a commercial basis, but some may be politically motivated as well. In the event that foreign lenders unload their Treasury holdings, or suspend a rollover of the securities due in an untimely manner—as was the apparent case experienced during the Fannie Mae and Freddie Mac financial meltdown in September—the Government may have to compromise its sovereign authority, succumbing to lenders' demands, such as debt repayment

guarantees by the Federal Government. Since foreign lenders are beyond the Government's control, it is imperative for the U.S. to maintain its sound fiscal and monetary policies so that reasonably low interest rates and maintaining the U.S. dollar as the international transaction and reserve currency can be preserved.

**Fifth:** The U.S. has a triplet deficits problem. Not only is the National Debt astronomical, but the household savings deficit is also extremely large. The U.S. is also running an external trade account deficit, which amounts to about 6 percent of GDP, and no nation can sustain this level of deficit for long. Many experts, both at home and abroad, warn the U.S. of the potentially grave consequences of its economy as well as that of the world, unless it reverses these triplet deficits trend.

**Sixth:** Finally, at current rates of borrowing and spending, this generation of Americans will pass on a daunting financial burden to the next and subsequent generations. Future generations are likely to face greater economic uncertainties from global competition for jobs, financial security, and a comfortable retirement, than those enjoyed by the current generation. In this context, the current generation has a moral obligation to deal with the above problems now and not to pass them on.

### **Are there any solutions?**

The current financial and economic crisis facing our government and the financial services sector has exacerbated the need to take action on deficits reduction in all areas discussed above, including ways of improving household savings. However, the timing of launching the needed adjustments is not propitious at a time when the current and prospective financial and economic conditions are under extreme stress, in tandem with the global economic downturn. Nevertheless, any further fiscal and monetary measures required to counter the current economic calamities, in addition to those already taken, must take into account the critical needs for reducing the National Debt. This may take place through tax increases, less essential expenditures reduction, or both, in order to maintain the longer term health of our national economy as well as that of the globe.