Implications of the National Debt

Revolutionary War

"The United States was born in debt" (Gordon pg11). By the end of the American Revolution, our new country had borrowed about $80million. Some was from the French government, Dutch bankers and wealthy patriots. But that was not enough. The main source of revenue was the printing press. The Congress issued fiat money called continentals. The continentals were backed by nothing more than the declaration that they were legal tender. By 1783 the United States was no longer paying interest on the internal debt, had defaulted on the foreign debt and was months behind in paying the army. Before the war ended, earlier issues of the $200 million of continentals were revalued to 2.5 percent of face value. Remember the phrase "not worth a continental" from American history. This fiscal crisis was one of the several that led to the adoption of the U.S. Constitution and the Bill of Rights.

Alexander Hamilton was appointed first Secretary of the Treasury by George Washington in 1789. The first budget was $2.8 million. More than 75 percent of the budget was used to retire Revolutionary War debt. "Within five years, America had gone from fiscal disaster to having the highest credit rating with European-creditors." (Yarrow pg 31)

War of 1812

The war of 1812 saw the national debt grow from $45 million to $127 million by 1816. Over the next twenty years, the debt fell to its all time low of $33,733.05 under Andrew Jackson in 1835. At the same time Jackson's hate and distrust of the "moneyed aristocracy" led him to allow the charter of the Second Bank of the United States to expire. He transferred government funds to his "pet banks". The supply of money increased fifty percent in eighteen months. This huge increase led to inflation, Wall Street's first speculative bull market in 1836, and rampant land speculation. In an attempt to rein in the land

speculation, Jackson issued an executive order requiring that land bought from the government for speculation to be paid only in gold or silver. Shortages and hoarding resulted causing the Panic of 1837. By the end of the depression in 1843, the national debt was back up to $32 million. By the end of the Mexican war it reached $68 million. By 1857 the deficit had declined to $28 million (Gordon pgs 59-65).

Civil War

The Civil War, which lasted four years, is estimated to have cost the nation between $6 – 7 billion. The Union spent a little over half of that, and financed the cost primarily by issuing government bonds. Regarding the borrowing Lincoln said that "men readily perceive that they can not be much oppressed by a debt which they owe themselves." About 28 percent of the North's costs were covered by increased excise taxes and a short lived income tax of 3 percent on incomes over $800. By 1866 the national debt was nearly $2.8 billion. From 1863 through 1981 the national debt would be measured in billions (Yarrow pgs 31-32).

From 1889, when GNP figures became available, until 1916 the national debt decreased from 10 percent to 2.54 percent of GNP. At the same time it was about $1.25 billion in each of those years (Gordon pgs 202-203). The modern income tax became permanent with the ratification of the Sixteenth Amendment in 1913 and Woodrow Wilson signed the first permanent income tax bill. Rates ranged from 1 percent to 7 percent on incomes over $500 thousand. Even so, less than 1 percent of the population paid taxes (Yarrow pg 33).

World War I

With America joining the First World War, Wilson won passage of the Revenue act of 1916 and two subsequent war revenue acts. The tax floor was lowered and the base rate was doubled to 2 percent.

The top rate was raised to 15 percent on incomes over $2 million. The estate tax was also established. Still, only 5 percent of the population paid taxes. By 1919 the national debt was $27.4 billion (Yarrow pg 33).

Between the Wars

During the 1920's Harding, Coolidge and Hoover ran budget surpluses, cut taxes five times, and retired about 40 percent of the war debt before the depression hit. The hardships of the Depression caused the national debt to grow by 40 percent during the three Depression years Hoover was president, and nearly double during Roosevelt's first eight years in office from $23.5 billion to $43 billion, or from 42 percent of GNP to 51 percent of GNP (Gordon pg 203).

World War II

World War II was financed mostly by the sale of bonds, but taxes were raised and the tax base was broadened too. The number of Americans filing returns grew from four million to forty-three million. Annual budget deficits grew to $55 billion in 1943, the equivalent of $486 billion in 2000 dollars (Yarrow pgs 34-37). The national debt ballooned from $43 billion in 1940 to $269 billion in 1946; that was 130 percent of GNP (Gordon pg 203)

Post World War II.

Even though there was rationing and wages were frozen, America was prosperous and fully employed during World War II. At the end of the war as the soldiers returned home, many feared that depression and high unemployment would return. However, due to numerous factors including "business-government-labor cooperation; huge government investment in wealth-generating infrastructure, technologies, and skills; pent-up and rising consumer demand and aspirations; public and private efforts

that all but ensured that incomes would keep increasing; and a war-devastated world that left America without any real economic competitors; the economy, Americans' and businesses' incomes , and federal government finances grew beyond people's wildest dreams over the next twenty-five years (Yarrow pgs 38-39).

Cold War and Viet Nam

During the 1950's government spending increased rapidly, in part, to fund the Cold War arms race. President Eisenhower was committed to raising purchasing power for all and was a believer in deficit spending to stimulate the economy in times of weakness. Social Security benefits were doubled under Truman and Eisenhower. The number of eligible families increased sevenfold with the passage of five amendments to the Social Security act. The top tax rate on incomes over $200,000 was 94 percent (Yarrow pgs 38-39).

The American economy grew at its fastest sustained pace in our history during the 1960's, yet the national debt grew from $287 billion to only $371 billion by 1970. This was in spite of Kennedy's tax cuts, deficit spending, and LBJ's "guns and butter" spending policies. For the purposes of this paper, the most significant events of the 1960's were the adoption of the Social Security Amendments of 1965 which established Medicare, and the passage of the legislation establishing Medicaid.

In 1972, due to Vietnam War era inflation, President Nixon and Congress indexed Social Security benefits to wage increases. As Andrew Yarrow writes, "The proverbial cat was out of the bag, as entitlement spending on Social Security, Medicare, and Medicaid – tiny in the 1960s – started to head for the inflation-adjusted stratosphere." In the latter half of the 70s under President Carter, Stagflation, declining productivity, and the sudden rise in entitlement costs contributed to the debt rising to $909 billion by 1980.

Reagan Years

Ronald Reagan was elected President in 1980 with a mandate to get the economy moving, cut deficits and taxes, and reduce the size of government. He was able to reduce taxes and cut some government spending. But, he tremendously increased defense spending as the Cold War entered its final decade, and he was unable to control the growth of entitlement spending. The national debt surpassed $1 trillion during his first year in office and rose to $2.8 trillion by the end of his second term (Yarrow pgs 42-43).

Early in Reagan's first term it became clear that Social Security was on the brink of disaster. To save Social Security, the 1983 Greenspan Commission proposed increasing Social Security and Medicare taxes to their current level of 15.3 percent, extend the full-benefit retirement age over three decades to age sixty-seven, reduce benefits for those who retire between sixty-two and full retirement age, tax the self-employed and Social Security benefits, and reduce cost of living increases (Yarrow pg 43).

The 1986 Tax Reform act provided tax benefits for poor and working class Americans. It broadened the tax base by closing loopholes and eliminating tax shelters, and it lowered the top marginal rate to a postwar low of 28 percent. By the end of the George H. W. Bush presidency, the Gulf War, the savings-and-loan bailout and a recession sent the national debt to $1.5 trillion (Yarrow pg 44).

Clinton Administration

With help from Presidential candidate H. Ross Perot, deficit reduction gained political momentum. That, and a lot of luck, led to substantial deficit reduction in the later Clinton years. While "Read my lips. No new taxes" was a loser for the first Bush, President Bill Clinton was able to get a five year deficit reduction bill through Congress that raised taxes and cut spending. In addition to $500 billion in nominal deficit reductions from 1990, and the 1993 measures, and more cuts in 1997, the high tech

boom of the late 90s caused federal revenues to skyrocket and deficits to shrink. The first budget surplus in 29 years was announced by President Clinton in 1998. In 1999 he announced that the national debt could be retired by 2015 (Yarrow pgs 45-46).

9/11 and the War on Terror

Surpluses were predicted to continue as far as the eye could see when the current President Bush was inaugurated in 2001. As is often the case, circumstances beyond one's control frequently intervene. The tech boom became the "tech wreck", the stock market crashed, we were attacked by terrorists on 9/11 which lead to the wars in Iraq and Afghanistan, and the ensuing recession led to lower income and reduced federal revenues. Along with tax cuts and huge spending increases, the national debt grew from $5.8 trillion to $7.4 trillion from 2000 through 2004 (U.S. Treasury). Almost 40 percent of the debt accumulated over the history of the United States came about during the first seven years of this Bush's administration (Yarrow pg 47).

Today – The Statistics

On September 30, the National Debt surpassed $10 trillion. Recently, The Wall Street Journal reported that the budget deficit for 2008 is a record $455 billion. The previous record was $413 billion in 2004. With all the various bailout, loan and liquidity plans, pundits and experts alike are predicting that next years budget deficit could top $1 trillion. At 11am today, the national debt was - $10,502,187,410,327.12 (National Debt Clock).

You have probably noticed that $10 trillion is a lot of money. As of September 30, the debt per U.S. resident was about $32,895 (Wikipedia, Unites States Public Debt). Approximately $5.3 trillion was public debt. That means debt held by any person, institution, business, state – foreign or domestic, except our federal government- that owns Treasury bills, notes, bonds, TIPS, Savings bonds, to name a

few. The balance of the $10 trillion is intra-governmental debt- mostly unsecured promises to repay Social Security previous borrowings and to pay for unfunded future benefits of Medicare, Medicaid and Social Security. The Public debt and the intra-governmental debt comprise the gross federal debt.

All together that adds up to current and future debt of about $59 trillion (Wikipedia, United States Public Debt). That is more than $516,000 per American household (USA Today). In 2007, public debt was 36.9 percent of GDP and gross federal debt was 65.5 percent of GDP. To put that in perspective, according to the CIA World Fact Book, America's gross federal debt places us 27th in the world, falling below France and Canada by this measure, and above the United Kingdom. Japan is third on the list at 107 percent of GDP.

Foreign investors and governments hold about 25 percent of gross federal debt, or about 50 percent of the public debt. As of July 31st of this year, Japan held 22.2 percent of the foreign debt, Mainland China held 19.4 percent, the United Kingdom 10.9 percent, and oil exporting countries 6.5 percent (Perot Charts).

I should note that the National debt and the federal budget deficit are not the same thing, The government operates on an annual budget for each fiscal year which begins on October 1st and ends the following September 30th. If receipts are greater than outlays at the end of the year, the budget has run a surplus. If the opposite is true, there is a budget deficit. The national debt is the accumulation of America's annual budget deficits. Budget surpluses can be used to reduce the debt.

The national debt is subject to a ceiling that may be raised only by Congress. The debt ceiling was most recently set at $11.3 trillion as part of the Toxic Asset Repayment Plan (TARP). This is the seventh time the debt ceiling has been raised during the George W. Bush administration.

This presentation is full of numbers which may be sufficient to make some eyes glaze. There is the possibility that they may not add up to the penny because of rounding and the use of different sources. The point is that all of the American people will be asked to pay and our elected representatives have promised that we will pay a sum, in the not too distant future, that will, under the current regime, dwarf our ability to pay.

The majority of this future debt is, primarily, the result of our ever expanding entitlement programs- Social Security, Medicare and Medicaid. Social Security receives most of the press, but the real elephant in the parlor is Medicare. With boomers soon to turn 65 in droves, and with healthcare costs growing faster than the population, faster than the prices of other goods and services, and faster than the overall economy, both programs will start running deficits in just a few years. (See Perot Chart.)

BURDEN OF THE NATIONAL DEBT

Assume the United States is operating at full capacity. Assume also, that we enter into a war and that the cost of that war results in a budget deficit that is financed by issuing government bonds. The resulting increase in government spending causes an increase in aggregate demand. In a fully employed economy, in addition to rising prices, the increase in demand will lead to a rise in interest rates. The increase in interest rates is how the government gets the additional money to fight the war because the increase will dampen interest-sensitive spending by the private sector. Businesses will be reluctant to spend more on capital equipment, plants and buildings. Households will spend less on appliances, cars and homes. This phenomenon is called “crowding out”. The result is a reduction in what America’s private capital stock might otherwise have been. Future generations will inherit this reduced capital stock, which implies a reduced level of economic output will be available for them.

The burden of the debt is then the lower level of output and it will be born largely by future generations. Some of the burden will be born by the current generation, however, for we will share part of the lower output for the remainder of our lives (Christensen pg 18).

Instead of issuing bonds to finance the budget deficit, the federal government can resort to the financing method used by the Continental Congress, the Confederacy and banana republics everywhere. It can print money to pay its bills. Would this manner of financing the national debt reduce the burden it places on future generations? The simple answer is yes, but there is a catch.

Financing Deficits and Debt

Financing a budget deficit in a fully employed economy by issuing money is inflationary. And inflation is a tax on the existing stock of money in that it reduces the purchasing power of that money. The inflation enables the government to obtain the resources necessary to fight the war by reducing the wealth and purchasing power of the private sector. The inflation tax crowds out private spending. Some of the spending may be on capital goods; however, the majority is likely to be for current consumption. Because it is current consumption that is reduced, the burden is mostly felt by the current generation. The inherited private capital stock is not likely to be reduced, so future generations will not suffer much of a reduction in their standard of living. Therefore, financing a budget deficit by printing non-interest-paying money instead of issuing interest-paying bonds does not eliminate the burden of the debt; it mainly places the burden on the current generation instead of shifting it to future generations(Christensen pgs 19-20).

Each year that the government operates with a deficit, there will be a line item in the budget for interest payable. Is there a burden imposed on future generations whose taxes will be used to pay the

interest? The answer is no. Money is transferred from the taxpayer to the bond holder. If they are the same person, they are neither richer nor poorer. If they are different people, one is poorer and the other richer. But the wealth of the United States as a whole has not changed. The payment of interest is not an additional burden of an internally held debt. The lower income enjoyed by future generations is the burden imposed on future generations by a diminished capital stock (Christensen pg 21).

The forgoing discussion of the burden of the national debt has addressed what is called the explicit national debt. It is that debt which we bear now and on which we are paying interest. Recently, however, economists have been doing work in the area of generational accounting and have come to an appreciation of the equivalence of explicit debt and implicit debt, that debt which the government has promised to take on in the future. The largest and best known implicit debts are for the future funding of Social Security, Medicare and Medicaid.

The easiest way to see that equivalence may be to look at the future of Social Security. As we all know, the current "pay as you go" method of funding Social Security will become insolvent as more and more baby boomers retire. In order to pay the promised future benefits, large payroll tax increases will be necessary. Therefore, future generations will have a larger part of their income taxed and transferred to Social Security recipients, leaving less money for them to spend on goods and services. Benefit reductions would create the same burden. Retirees receiving lower benefits would be able to purchase fewer goods and services as well. The burden of higher taxes would be felt by workers from the date the taxes are raised. The burden of lower benefits would be felt by retirees from the date benefits are reduced (Christensen pg 23).

Implications

What does the apparent future of the national debt imply? If you are a part of the "deficits don't matter" crowd, any thing from "not much" to "the United States is way under borrowed." The under borrowed thesis was clearly explained in an article last year by Kenneth L. Fisher, the founder and president of Fisher Investments and a columnist for Forbes Magazine, that was published in varying forms in several publications. He figures that with assets of around $120 trillion and a GDP of about $13 trillion, we can just about triple our level of debt to maximize our return on assets. And as long as we are underleveraged it doesn't matter who loans us money.

Well, I'm a conservative mid-west financial nerd. My idea of good debt is an unused home equity line of credit. Too conservative; maybe, but I sleep pretty well most nights. So, I am of the "less debt is better" school. On the other hand I do understand there are benefits to government debt. Those benefits are primarily ones that enhance liquidity of the markets, provide a risk free interest rate benchmark and help to keep the prevailing level of rates somewhat lower. I'll leave the discussion of what level of debt is optimal to the academics.

No one can know for sure what will happen if we continue on our present course. We could get lucky. The current crisis could end smoothly and quickly followed by years of sustained economic growth. Or, we could suffer a meltdown that makes the Great Depression look like a financial hiccup. Chances are the true path will be somewhere in between.

Policy makers and economists of all political persuasions agree that deficits and debt have many possible negative consequences. The most important may be reducing saving for our future and investments in our society and economy of the future. Saving is necessary if our economy is going to grow and our standard of living is going to improve. And it makes a difference what public, private and personal investment is for. Is it for productive purposes like energy efficient transportation, mapping the

human genome, paying for our children's education, or something less useful, such as interest on the national debt, funding the run away costs of Medicare and Medicaid, bailing out businesses whose executives were at best imprudent and convinced that this time it was different, or lining the pockets of foreigners at the expense of our grandchildren's future standard of living (Yarrow pgs 61-62)?

By spending more and more on entitlements and interest we are crowding out spending on the things that make our lives better- the environment, medical research, increasing the effectiveness of public education, domestic security, private investment, and global competitiveness. Peter G. Peterson, former Secretary of Commerce under President Nixon, notes that "future oriented" spending has declined from about 32 percent of outlays in 1965 to 14 percent in the year 2000. Deficit spending hampers the ability to spend on the unpredictable; floods, earthquakes, terrorist attacks, epidemics. State and local governments feel the pinch as well. Medicaid costs are straining their budgets causing them to have to cut spending in other areas such as state universities. What about unfunded mandates passed into law by Washington like No Child Left Behind (Yarrow pg 63)?

When the federal government, business and individuals compete to borrow money, the cost of money, interest rates, goes up. That increases mortgage payments, car payments, and credit card payments. All together, the average American could see interest costs increase by $3,000 per year using realistic assumptions. If interest rates become unrealistic….just imagine. Also, our economy has relied on consumer spending for a large portion of its growth. High interest rates would depress borrowing for all the neat things that we buy. Consumer restraint will depress the economy and could force many small businesses into bankruptcy. It would certainly discourage entrepreneurs from undertaking new ventures. On the other hand, if the Federal Reserve adopts an expansionary policy, credit is easy and can lead to inflation by driving up prices. The government could also print lots of new money with the same result. That will also weaken the dollar which is inflationary (Yarrow pg 64).

John McCain is quoted as saying “We’re hurting our children, our grand children, and who knows how many future generations of Americans. It is perhaps my greatest hope, Mr. President, that someday we’ll consider tax and spending measures with no one else in mind but future generations of American taxpayers. We’re tying a millstone of debt around their necks, and it is a grave mistake.” Barack Obama said “We’re mortgaging our future. We’re taking a credit card for our children, in our children’s name and our grandchildren’s, and we’re running up the card and being completely irresponsible.” Lawrence Kotlikoff of Boston University has estimated that Americans born before the end of World War II will have received, as a group, $11.5 trillion more in Social Security benefits, on a present value basis, than the taxes they paid. Those born since then, who make up 90% of the population, will get back slightly less than they contributed. The more you make and the younger you are the less you will get back from Social Security (Yarrow pg 65).

This means that future generations are having their freedom stolen from them before they are old enough to do anything about it. If most government spending is mostly entitlements and interest, our successors won’t have the financial freedom to spend on what is new, needed and unexpected. Your grandchildren won’t have the freedom to choose how their tax dollars are spent. Their ability to pursue the American dream will be derailed by higher taxes and interest payments. As mentioned earlier, part of the burden of the national debt is a lower standard of living for future generations. If the rate of economic growth slows from 3 percent on average to 1.5 percent, it will take forty seven years for incomes to double instead of twenty four. They may have to work more hours and/or more jobs just to keep up, let alone realize their dreams.

Martin Feldstein, the president of the National Bureau of Economic Research, has suggested that if nothing is done, income taxes will have to be increased by one-third to one-half over the next twenty years. At current growth rates, taxes in constant dollars would have to rise by $7,000 for the average

taxpayer. Social security and Medicare taxes would rise too. Right now, the Social Security tax is 12.4 percent on the first $108,000 of income and could increase by 3 to 5 percent, and the Medicare tax at 2.9 percent of all income could rise by 3 to 10.5 percent. That could mean a jump from 15.3 percent today to 27.4 percent. Remember, income tax is likely to go up too (Yarrow pg 66).

No matter what happens to taxes, benefits will be cut as the cost of providing them escalates over the next ten or twenty years. If nothing at all is done about Social Security, in 2041 when the trust fund is exhausted, benefits will have to be reduced by about 25 percent because of its pay-as-you –go funding. Under some current reform proposals, the biggest losers are those under age 25. Realize that for two-thirds of Social Security recipients, their monthly check, which averages about $900, represents more than half of their income. For 17 percent of beneficiaries it is there only income (Yarrow pg 67).

Conclusion

"While all of these economic costs – lower wages, higher interest payments, higher taxes, and declining benefits – add up, there is a subtler aspect to stagnant or declining living standards. Put simply, this was never what America is about. This nation was founded and has grown on the promise of better tomorrows, and, over the long haul, it has delivered. Particularly in the era after World War II, the nation brought rapidly rising incomes to most of its citizens. If that were to end, what would they say about America and what would it do to American's confidence in their country and its future? The psychological costs of a debt-induced fall in living standards are hard to calculate. People would probably become more pessimistic and depressed about their own futures and their nation's. Those who might escape these horrors – the rich – might become the object of considerable antipathy. Public cynicism – already high toward government and many other institutions – would be likely to rise, and patriotism might start to wane."

Deficits, depression, declining patriotism, intergenerational turmoil, and civil unrest all may be possible if America falls from the economic and geopolitical summit. Like the Ghost of Christmas Future, this is not a prediction, only a picture of what may be if Americans continue to ignore the future. As Cicero said, “The budget should be balanced; the treasury should be refilled; public debt should be reduced; and the arrogance of public officials should be controlled.” It is our responsibility to raise public awareness and hound and shame our leaders into thinking beyond the next election.

Thank You.