Backgrounder

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Why America's Debt Burden Is Declining

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The Congressional Budget Office's new budget estimates are once again focusing budget watchers on the issue of government debt. While the growing federal debt is worrisome, many lawmakers and reporters focus on the wrong numbers and oppose debt for reasons that are not supported by economic data.

First, annual budget deficit figures, which are cited frequently by budget watchers, say little about the nation's true debt burden and its ability to finance this debt. Second, the legacy of government debt is steep increases in taxes rather than steep hikes in interest rates. Federal debt represents government's failure to live within its means as well as a preference for dumping current costs into the laps of future generations—with interest.

When measured properly, the federal government's debt burden is actually below the post–World War II average. It is lower than it was at any time during the 1990s. However, unless Social Security and Medicare are reformed, lawmakers risk allowing debt levels to increase until they cause the highest intergenerational tax increase in history.

Budget Deficits Versus Debt Ratios

For example, is a family carrying too much debt if it borrows $5,000 this year? That question cannot be answered without knowing two additional variables:

1. **Total debt**. The family must repay not only the amount borrowed this year, but also all outstanding debt from previous years. If the

Talking Points

- Annual budget deficit figures say little about the nation's true debt burden. Rather, the total debt as a percentage of GDP—known as the "debt ratio"—is the best measure of the nation's debt burden.
- America's current 38 percent debt ratio is below the post–World War II average of 43 percent and lower than it was at any time during the 1990s. The debt ratio is declining because the economy is growing six times faster than the national debt.
- Higher taxes—not higher interest rates—are the main legacy of government debt. Governments that do not restrain spending and live within their means must eventually collect additional taxes from future generations.
- Tax increases fail to reduce the debt ratio. While total debt may decrease, long-term economic growth will likely decrease as well, leaving the debt ratio essentially unchanged.

This paper, in its entirety, can be found at: *www.heritage.org/budget/bg1820.cfm*

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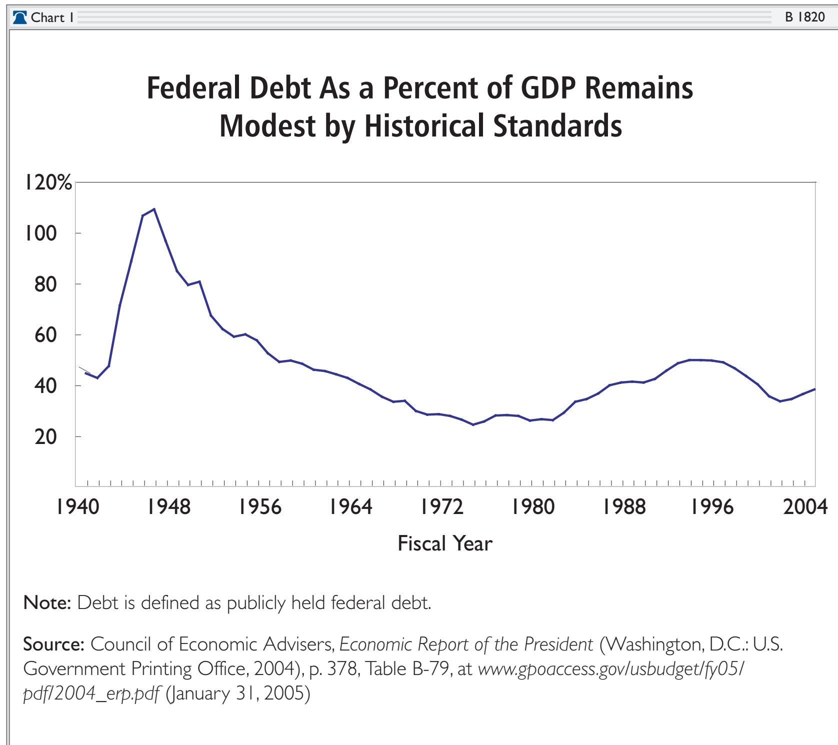
family still owes $95,000 from previous borrowing, the additional $5,000 is less affordable than if the family had no prior debt.

2. **Income.** Assuming the family was already $95,000 in debt and this new $5,000 loan increases its total debt to $100,000, whether or not the additional $5,000 in debt is manageable depends on the family's income. While Bill Gates could easily afford this debt, many low-income families could not.

Combining these two variables, the proper way to measure the impact of borrowing is by calculating the total debt as a percentage of income. This "debt ratio" is used by banks to determine how large a loan families and business can afford.



Note: Debt is defined as publicly held federal debt.

Source: Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2004), p. 378, Table B-79, at *www.gpoaccess.gov/usbudget/fy05/pdf/2004_erp.pdf* (January 31, 2005)

The same common sense applies to measuring the federal government's finances. A $413 billion budget deficit merely shows the approximate annual change in the national debt. However, that number reveals nothing about whether or not the debt burden is too high; nor does it show whether the overall debt burden is increasing or decreasing.

Just as an individual's debt ratio is calculated in terms of total debt as a percentage of annual income, the government's debt ratio is calculated in terms of publicly held debt as a percentage of gross domestic product (GDP).[1] This measures total debt as a percentage of national income and therefore helps determine how much of a burden the national debt is placing on the American economy.

Economic Growth Is Reducing the Debt Ratio

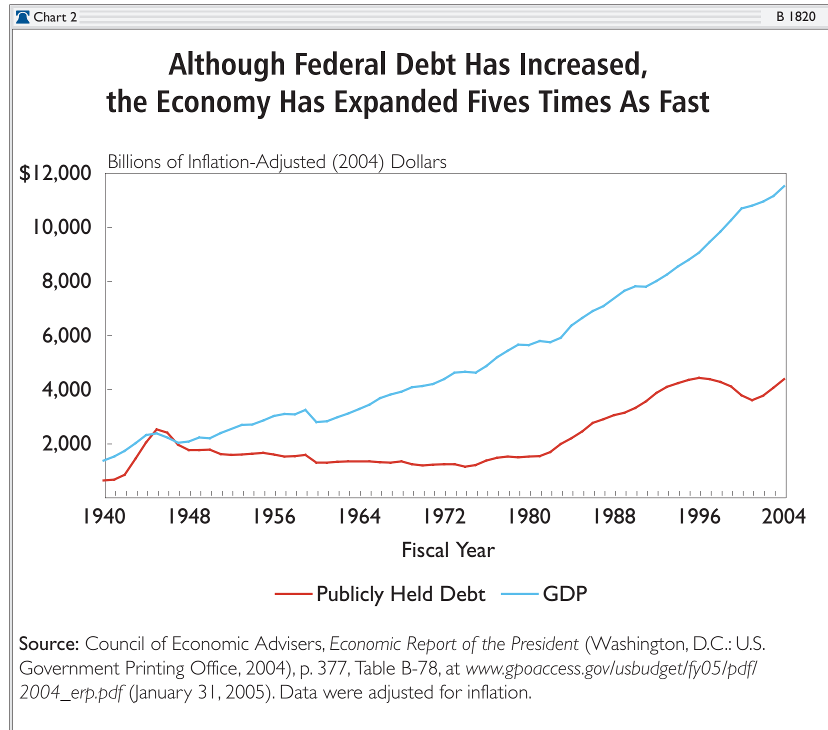
Chart 1 shows America's debt ratio since 1940. In 2004, America's $4.3 trillion debt represents 38 percent of its $11.6 trillion GDP. Despite all the hand-wringing over increased budget deficits, the 38 percent debt ratio is actually *below* the post–World War II average of 43 percent. Consequently, America's debt burden is actually low by historical standards.[2]

During World War II, the debt ratio surged from 40 percent to 109 percent, meaning the nation's debt was actually larger than its GDP. After dropping down to 23 percent of GDP by 1974, the debt ratio increased to 49 percent by 1994 before dropping to 38 percent in 2004.

1. Government debt is defined herein as publicly held debt. To the extent that one federal agency owes money to another federal agency, some federal debt is held by the federal government itself, but that internal debt does not affect financial markets significantly. Instead, it represents a future obligation of the federal government to raise taxes or reduce spending in order to repay the agency that loaned the money. That debt is excluded from this analysis.

2. All debt ratio numbers were calculated using data from Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2004), p. 378, Table B-79, at *www.gpoaccess.gov/usbudget/fy05/pdf/2004_erp.pdf* (January 31, 2005).

There is no mystery to why the debt ratio has dropped so much since World War II: Economic growth has dwarfed the amount of new debt. Since 1946, inflation-adjusted debt has grown by 84 percent, but the economy has grown by 429 percent—more than five times as fast. (See Chart 2.) Just as a family with rising income can afford to buy a more expensive home and take on more mortgage debt, the growing American economy has been able to absorb its new debt.



Source: Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2004), p. 377, Table B-78, at *www.gpoaccess.gov/usbudget/fy05/pdf/2004_erp.pdf* (January 31, 2005). Data were adjusted for inflation.

Economic growth has played a large part in the recent declines as well. Since 1994, the national debt has expanded by 6 percent while the economy has grown by 35 percent. This has reduced the debt burden from 49 percent to 38 percent. In fact, the current debt ratio is below the level for every year of the 1990s. Thus, it is not surprising that recent budget deficits have not devastated the economy.

Debt Ratios and Interest Rates

The most commonly cited argument against budget deficits is that they substantially raise interest rates, but the numbers tell a different story. Since 2000, the $236 billion budget surplus has been replaced by a $413 billion budget deficit. However, instead of rising, the real interest rate on the 10-year Treasury bond has actually *dropped* from 2.6 percent to 1.8 percent.[3] (See Chart 3.)

The first and most obvious reason for this disconnect is the erroneous focus on the budget deficit rather than the debt ratio. While the $649 billion decline in the nation's fiscal position seems very large, the debt ratio has barely budged, rising from 35 percent to 38 percent. That is not an extraordinary movement in the nation's debt burden.

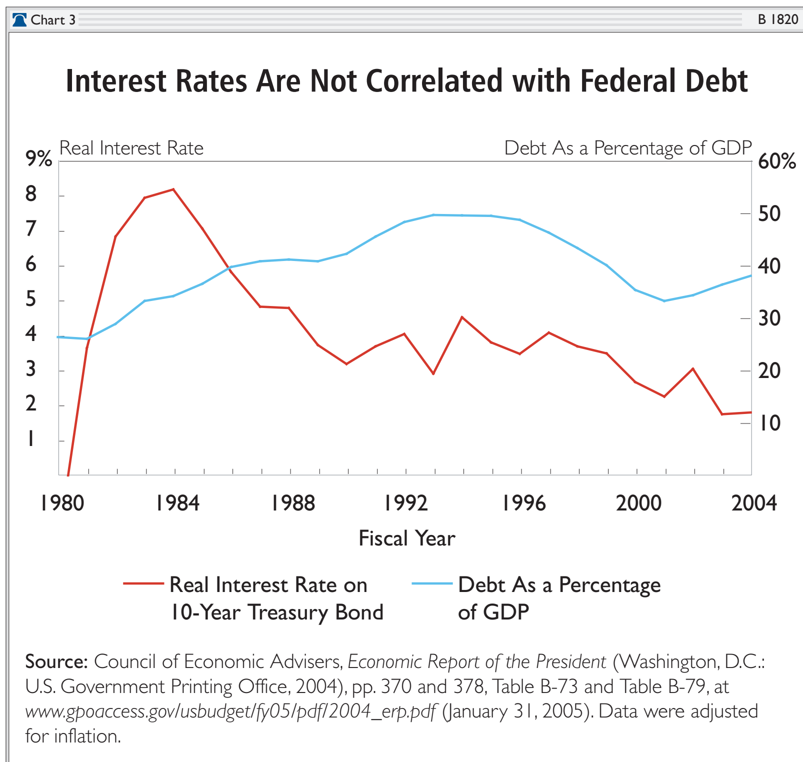
The second issue is whether or not increasing the debt ratio really causes higher interest rates. In theory, higher demand for a good or service will cause higher prices. Money is no different: An increase in the demand for borrowing money will increase the price of borrowing money (i.e., the interest rate). This is true regardless of whether the borrower is a government, a corporation, or an individual.

The more important question is by *how much* the interest rate will increase, and that depends on how much is being borrowed and whether the market is large enough to absorb that amount. Today's global economy is so large and integrated—trillions of dollars move around the globe each day—that it can easily absorb the federal government's borrowing without triggering a substantial increase in interest rates.

Harvard economist Robert Barro[4] studied the economies of 12 major industrialized countries and found that:

3. Council of Economic Advisers, *Economic Report of the President*, p. 370, Table B-73 (and adjusted for inflation). The 10-year Treasury bond is a good benchmark interest rate because many corporate and personal interest rates—including some mortgage rates—follow this interest rate. During the 2000–2004 period, the nominal interest rate dropped from 6.0 percent to 4.2 percent.

1. Not surprisingly, real interest rates can be influenced by the debt ratio, not the annual change in budget deficits.
2. Overall debt-to-GDP ratios across the 12 countries matter more than what happens in one country. If one country borrows to finance its debt, capital seekers can still find cheap capital in other countries, thus averting the shortage that would raise interest rates.
3. An increase of 1 percentage point in America's debt-to-GDP ratio raises interest rates by approximately 0.05 percentage point. If all 12 countries increased their ratios by 1 percentage point, interest rates would increase by approximately 0.1 percentage point.



Source: Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2004), pp. 370 and 378, Table B-73 and Table B-79, at *www.gpoaccess.gov/usbudget/fy05/pdf/2004_erp.pdf* (January 31, 2005). Data were adjusted for inflation.

In other words, raising interest rates by just 1 percent would require all 12 nations to raise their debt ratios by a full 10 percentage points.

If just the United States incurred all new debt, the effect on interest rates would be much smaller. Research by the American Enterprise Institute's Eric Engen and Columbia University economist (and former chairman of the Council of Economic Advisers) Glenn Hubbard shows that a 1 percentage point increase in the U.S. debt ratio increases long-term interest rates by approximately 0.035 percent. In other words, it would take a 29 percent increase in the U.S. debt ratio—totaling $3.3 trillion in new debt—to raise long-term interest rates by just 1 percentage point.[5]

Furthermore, while debt ratios may slightly affect interest rates, these small movements are usually overwhelmed by larger trends affecting real interest rates, such as economic growth and expectations of future inflation.

Federal Spending and Debt

The largest danger posed by rising debt is that it represents a claim on future taxes. Interest on the federal debt cost taxpayers $160 billion in 2004, and these costs will increase as interest rates move up toward historically high levels. Even if Washington continues to roll over its debt (thus permanently deferring the principal), increased borrowing will mean rising interest costs.

This debt is the result of lawmakers spending beyond the nation's means. In 2004, Washington collected $1,880 billion in revenues but spent $2,292 billion. Families and businesses have to live within their means, and so should lawmakers.

Some analysts support raising taxes to reduce the debt ratio. This method is doomed to fail because, although tax increases may reduce the federal debt, they also reduce economic growth by reducing incentives to work, save, and invest.

4. Robert Barro, "Have No Fear: Bush Tax Plan Won't Jack Up Interest Rates," *Business Week*, May 5, 2003.
5. Eric Engen and R. Glenn Hubbard, "Federal Government Debt and Interest Rates," American Enterprise Institute *Working Paper* No. 105, June 2, 2004, p. 1, at *www.aei.org/docLib/20040825_wp105.pdf* (January 31, 2005).

With both the debt and the GDP decreasing, the debt ratio would not be likely to improve at all. Americans would have sacrificed their tax dollars and a healthy economy for nothing.

Instead, the best way to reduce the long-term debt burden is to combine spending restraint with a pro-growth tax policy that keeps America's debt levels affordable. Unlike the tax increase option, spending restraint promotes economic growth, retains a low tax burden, and can actually succeed in reducing the debt burden. With corporate welfare, pork-barrel projects, obsolete programs, and waste totaling hundreds of billions of dollars annually, lawmakers have little excuse for not streamlining spending.

Social Security and Medicare pose the most serious danger to long-term spending restraint. Together, these programs face an unfunded liability of $33.2 trillion,[6] which is eight times larger than the current national debt. Without reform, lawmakers have two choices: They can either raise taxes to levels unseen in American history or increase the debt ratio to levels comparable to levels experienced during World War II. Either way, Americans could expect substantially higher taxes, lower incomes, and more poverty.

Conclusion

The obsessive focus on budget deficits is misguided. The debt ratio, a superior measure of government's debt burden, is as dependent on economic growth as federal borrowing. The past decade has shown that a growing economy can absorb modestly increasing debt levels.

The danger of debt is that it represents a claim on future taxes. Streamlining wasteful spending while pursuing a pro-growth tax policy can simultaneously reduce debt levels and make debt more affordable. On the flip side, attempts to reduce the debt burden by raising taxes backfire because the declining debt would be accompanied by declining economic growth, likely canceling out any improvement in the debt ratio.

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6. Centers for Medicare and Medicaid Services, 2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, March 23, 2004, p. 182, at *www.cms.hhs.gov/publications/trusteesreport/2004/tr.pdf* (February 2, 2005).