WebMemo
Published by The Heritage Foundation

No. 1648
September 28, 2007

Increasing the National Debt Limit Should Spur Congress to Tackle Entitlements

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In a flurry of business to close out the fiscal year, Congress raised the debt limit by $850 billion to $9.815 trillion. Without this move, the federal government's credit card would have maxed out on October 1 with an outstanding balance of $9 trillion. This staggering amount, also known as the national debt, is equal to $29,700 per American or $78,680 per household. Because the government must fund existing programs and make interest payments on existing debt, Congress had no choice but to raise the debt limit to prevent America's credit card from being cut in two.

Eventually, however, America will have to either pay its bills or raise the debt limit to catastrophic levels. Absent reform to Medicare and Medicaid, those programs will grow at unsustainable rates, and future generations will inherit a crushing debt burden. While the current debt is not large by historical standards, Congress must reform entitlements in order to avoid unsustainable levels of debt in the future.

The Scope and Consequences of the National Debt. The total debt has two parts. The first part is debt held by the public, which is owed to individuals, corporations, the Federal Reserve, and state, local, and foreign governments that purchase bonds and other Treasury Securities. The public debt makes up $5.1 trillion of the overall debt. The second part is debt held by the government, which represents money that was borrowed by the government from surpluses in the Social Security Trust Fund and other government accounts. Government debt makes up the remaining $3.9 trillion of the total national debt.

Debt held by the public is marked by features of the past and present. It is the total of all past budget deficits plus interest, and it reflects the government's present demand on credit markets. Each of these features has important economic consequences. First, the government is required to pay interest on the debt it has accumulated in the past, or else it risks default. In fiscal year 2007, interest payments on the public debt are estimated at $233 billion, which is roughly 8 percent of the federal budget.1 These interest expenses increase budget deficits (or reduce surpluses) every year. The larger these interest payments become, the less budgetary flexibility the government has to meet other spending priorities.

Second, the public debt has a direct effect on credit markets. Each year, the government must sell Treasury Securities to finance the federal deficit. The deficit for fiscal year 2007 is projected to be $158 billion.[2] The securities that are sold will compete with private securities and will reduce the amount of money put toward national savings. As a result, the money available for private investment will be diminished, and lower private investment will decrease worker productivity, leading to lower wages and lower economic growth.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Budget/wm1648.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
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Debt held by the government, on the other hand, can be thought of as future debt. Because government debt is issued from one part of the government to another, issuing this debt is really just an accounting mechanism. As such, it does not require interest payments nor does it affect the current credit market. Any economic impacts of government debt will be felt in the long term, when the time comes for the government to repay its debts to itself.

Unto itself, debt is not intrinsically bad or good. For instance, during a recession, debt is an important mechanism for avoiding higher taxes that would otherwise send the economy into a deeper recession. Similarly, during a national emergency such as a natural disaster or a terrorist attack, debt can be a helpful instrument for shoring up revenue without having to disrupt the rest of the economy through massive tax increases or deep spending cuts to other important programs. The wrong use of debt is to fund non-emergency programs that are supposed to have a fixed place in the budget. Over the long-term, borrowing for the year-to-year operations of these types of programs will add up and become unsustainable.

Debt and the Long-Term Outlook. Although it has no immediate economic impact, debt held by the government becomes significant over the long-term. Such debt will eventually have to be converted into public debt, which means its economic impact will be felt by future generations. For instance, in 2017 the Social Security system will need to begin drawing from the Trust Fund in order to pay benefits. Since the Trust Fund contains nothing but government debt, the government will need to generate cash to pay back the money it has borrowed. Absent large budget surpluses in the future (a highly unlikely prospect), repaying government debt will necessitate that debt be sold to the public. This shifting of government debt to public debt will not by itself cause the total stock of debt to change, but it will force the Treasury to begin making interest payments that it was earlier able to avoid. As these new interest payments compound, the debt will rise significantly. Absent any other policy changes, the Congressional Budget Office (CBO) estimates that net interest on the public debt will rise to 12.4 percent of GDP in 2050, which will amount to more than $9 trillion per year.[3]

If current policy does not change over the long-term, yearly deficits will continue to pile up, which will require new debt be sold to the public. The main drivers of future spending that will necessitate borrowing are Medicare and Medicaid.[4] These programs will expand dramatically due to rising health-care costs and the aging of the Baby Boomers. From 2005 to 2050, Medicare is projected to grow from 3 percent to 9 percent of GDP, and Medicaid will grow from 1.5 percent to 4 percent of GDP. These programs will have a direct effect on the debt because they rely on general revenue to pay for benefits; thus, significant additional borrowing will be required to cover these increasing costs.[5] While the public debt today stands at approximately 39 percent of GDP, the CBO estimates that the federal debt will skyrocket to 246 percent by 2050 if all this spending comes to full fruition.

Debt levels of this magnitude would be simply unsustainable. Historically, debt held by the public has averaged about 46 percent of GDP. If debt

1. Congressional Budget Office, "Monthly Budget Review," September 7, 2007, at *www.cbo.gov/ftpdocs/86xx/doc8607/09-2007-MBR.pdf* (September 10, 2007).
2. Congressional Budget Office, *The Budget and Economic Outlook,* August 2007, p. 2, at *www.cbo.gov/ftpdocs/85xx/doc8565/08-23-Update07.pdf* (September 10, 2007).
3. *Ibid.*
4. Social Security's future costs are funded by the Trust Fund, which is debt held by the government, through 2041. As this government debt is repaid through public debt, this will have the effect of increasing net interest on the public debt. However, after the Trust Fund is paid off in 2041, Social Security is prohibited by law from borrowing to pay benefits, which means new debt cannot be issued. Because the real impact of Social Security is felt through interest on the Trust Fund only, Social Security is not included on the list of major debt drivers.
5. While Medicare Part A relies on a Trust Fund for funding at present, it will be exhausted in 2019, at which time Part A will require general tax revenues to pay benefits. Since this section is focused on the long term, this distinction will be left aside.

reached 246 percent of GDP, it could crush the economy by removing all budgetary flexibility and creating an unprecedented government demand on capital markets.

Conclusion. While today's $9 trillion debt seems high, it is small compared to the debt that future generations stand to inherit. In order to spare them this crushing burden, Congress must act now to reform entitlement programs, which will become the main drivers of government spending and borrowing. If it does not, Congress will have to raise the debt limit many more times, and future generations will pay the price.

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