Backgrounder

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Ten Myths About Budget Deficits and Debt

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After three consecutive years of decline, this year's rising budget deficit has focused budget watchers on the issue of government debt. While the growing federal debt is worrisome, the current public debate over government debt and deficits has fallen victim to popular mythology and all-or-nothing rhetoric.

Vice President Dick Cheney is famously reported to have said that "deficits don't matter." On the other side, many deficit hawks give the impression that deficits are the *only thing* that matters; that a budget's success or failure is wholly determined by whether it balances or not, and the actual tax and spending policies are of secondary importance.

Reality is between these two extremes. On the one hand, government 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. This year alone, interest on the national debt (including all past deficits) will cost taxpayers $234 billion (8 percent of total spending).

On the other hand, modest government debt levels do not significantly raise interest rates or reduce economic growth. Specific tax and spending policies have a much greater impact on economic performance and social outcomes than whether or not the budget balances. While paying the interest is burdensome, few would argue that the United States should not have gone into debt to fund its World War II engagement or past economic policies that made Americans significantly wealthier.

Talking Points

- The 2001 and 2003 tax cuts did not cause the budget deficit. Even without any tax cuts, the budget would have fallen into deficit because of national security, runaway spending, and economic factors.
- At 38 percent of GDP, the publicly held national debt is actually below the historical average, and below the 1990s levels.
- The national debt is not large enough to raise interest rates or have a significant economic impact. The main drawback is the taxpayer cost of paying interest on the debt.
- Today's public debt of $5.4 trillion should concern lawmakers less than the $42.9 trillion in unfunded Medicare and Social Security costs over the next 75 years.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Budget/bg2178.cfm

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When properly measured, the federal government's debt burden is *below* the post-World War II average. It is currently lower than at any time during the 1990s, and is expected to remain roughly stable for the next few years under current policies. However, unless Social Security, Medicare, and Medicaid are reformed, lawmakers risk allowing debt levels to increase to the point of economic calamity—and the highest intergenerational tax increase in history.

Part 1: Causes of Recent Surpluses or Deficits

The first three myths examine the causes of the 1990s budget surpluses and the 2000s budget deficits.

MYTH #1: The 1998–2001 budget surpluses resulted from courageous sacrifices by President Clinton and the Republican Congress.

Fact: The end of the Cold War and the tax receipts from an economic and dot-com boom balanced the budget.

A popular narrative credits President Bill Clinton's tax and spending policies with finally balancing the federal budget from 1998 through 2001. In reality, the deficit was temporarily eliminated by two factors largely outside the control of the President and Congress: the end of the Cold War and the late-1990s economic and stock market boom.

The Clinton presidency saw a budget deficit of 3.8 percent of gross domestic product (GDP) transformed into a 1.3 percent of GDP budget surplus. Nearly this entire 5.1 percent of GDP shift occurred among tax revenues, defense spending, and net interest costs.[1]

1. Tax revenues rose by 2.2 percent of GDP. While President Clinton's 1993 tax increases increased revenues somewhat, they did not fully take off until 1997 when the economy began booming, triggered in part by capital gains tax relief.
2. Defense spending dropped by 1.4 percent of GDP. The end of the Cold War brought a "peace dividend" that temporarily reduced defense spending from 4.4 percent of GDP to an underfunded 3.0 percent—a reduction of one third.
3. Net interest spending fell by 1.0 percent of GDP. This was a residual of the lower debt ratio resulting from the revenue and defense movements. Slightly lower interest rates were also a contributing factor.

Other spending across the government dropped by 0.5 percent of GDP, with most savings attributed to a reduction in the cost of unemployment benefits as the economy grew.

President Clinton and the Republican Congress did not play a leading role in the stock market and dot-com boom (nor the subsequent bust), and did not cause the 1991 collapse of the Soviet Union.[2] Yet those two variables explain the vast majority of the swing from deficits to surplus. To the extent that lawmakers deserve credit, it is for staying out of the way. Spending on other programs was generally held in check, free trade was promoted, and Washington resisted urges for additional tax increases or regulations that would have killed the goose laying the economic golden egg.

MYTH #2: The post-2001 budget deficits were caused by President Bush's tax cuts.

Fact: National security, domestic spending, and economic factors played a larger role.

Just as President Clinton receives too much credit for balancing the budget, President George W. Bush receives too much blame for creating a budget deficit. But similar to the 1990s surpluses, the 2000s deficits were heavily influenced by global and economic factors that Washington cannot fully control. A 2001 budget surplus of 1.3 percent of GDP has transformed into a (projected) 2.2 percent of GDP budget deficit in 2008—a 3.5 percent of

1. Spending figures as a percentage of GDP calculated by The Heritage Foundation using figures from the Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2009*, 2008, pp. 56–73, Table 3.2 (outlays) and pp. 24–25, Table 1.2 (GDP), at *http://www.whitehouse.gov/omb/budget/fy2009/pdf/hist.pdf* (September 1, 2008).
2. The Soviet Union's demise occurred before Bill Clinton was elected President, and before the Republicans won control of Congress. In the 1980s, the Reagan Administration put into motion the U.S defense and foreign policies that ultimately played a large role in winning the Cold War.

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GDP shift. Similar to the 1990s, the two lead causes of the budget swing are found in tax revenues and national security spending, although domestic spending hikes also contributed (see Chart 1).

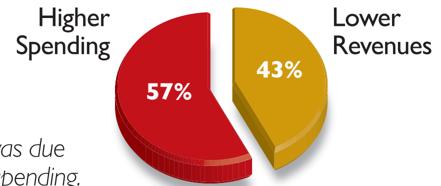
1. Tax revenues declined by 1.5 percent of GDP between 2001 and 2008. While an exact calculation is impossible, it is likely the Bush tax cuts lowered revenues by perhaps 1.0 percent of GDP, and economic factors (primarily the bursting stock market bubble) are responsible for the remaining 0.5 percent of GDP revenue reduction from the 2001 level.[3]
2. Defense spending increased by 1.2 percent of GDP. The 9/11 attacks played a lead role in this defense budget hike, which merely replenished the military budget after deep cuts in the 1990s.
3. Domestic spending increased by 1.1 percent of GDP. Medicare spending increased by 0.6 percent of GDP, while Medicaid, antipoverty, education, health research, and veterans spending together added 0.7 percent of GDP (an amount partially offset by slight reductions elsewhere).

A fourth category, net interest spending, actually declined by 0.3 percent of GDP as low interest rates compensated for added debt.

Thus, the three factors over which Washington had little realistic control—the growth of global terrorism and the need to respond with additional defense spending (1.2 percent of GDP), economic factors reducing tax revenues (0.5 percent of GDP), and net interest savings caused by lower interest rates (savings of 0.3 percent of GDP)—were enough to eliminate the 1.3 percent budget surplus. In other words, those external national security and economic events would have driven the budget into deficit even if President Bush and Congress had never reduced taxes by 1.0 percent of GDP and increased domestic spending by 1.1 percent of GDP.

Why Did the Budget Surplus Vanish?

Most of the swing from the 2001 budget surplus to the 2008 budget deficit was due to increases in spending.



Note: Comparisons made using percents of GDP. A 1.3 percent of GDP surplus fell to a 2.2 percent of GDP deficit.

Source: Heritage Foundation calculations based on Office of Management and Budget data.

Chart 1 • B 2178 heritage.org

MYTH #3: The 2001 and 2003 tax cuts cancelled out the $5.6 trillion projected 10-year budget surplus.

Fact: Those budget surplus estimates were based on unrealistic estimates.

Many taxpayers have wondered what happened to the projected $5.6 trillion 2002–2011 budget surplus that the Congressional Budget Office (CBO) famously projected in January 2001. A popular misperception claims that the 2001 and 2003 tax cuts cancelled out the majority of this surplus.[4]

In reality, this surplus projection was wildly unrealistic, as both the revenues and spending estimates were way off base. The CBO projected that revenues would average 20.3 percent of GDP throughout the entire decade—even though that

3. A static score of the 2001 and 2003 tax cuts comes to approximately $200 billion annually. However, a portion of this lost revenue has been recouped from resulting additional economic activity (particularly from the capital gains, dividends, and marginal income tax rate reductions). Even assuming a modest feedback effect of 25 percent brings the total cost of the tax cuts to approximately $150 billion, or 1 percent of GDP. See Brian M. Riedl, "Ten Myths About the Bush Tax Cuts," Heritage Foundation *Backgrounder* No. 2001, January 29, 2007, at *http://www.heritage.org/Research/Taxes/bg2001.cfm*.

4. Unless otherwise noted, data in the section comes from the Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002–2011*, January 2001, pp. 4–5, Table 1-2, at *http://www.cbo.gov/ftpdocs/27xx/doc2727/entire-report.pdf* (September 1, 2008). For final data, see Congressional Budget Office, Historical Budget Data, *Revenues, Outlays, Deficits, Surpluses, and Debt Held by the Public, 1968 to 2007, in Billion of Dollars*, at *http://www.cbo.gov/budget/data/historical.shtml* (September 1, 2008), and Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2009*, March 2008, at p. 44, Table A-1, at *http://www.cbo.gov/ftpdocs/89xx/doc8990/03-19-AnalPresBudget.pdf* (September 2008).

level had been reached only three times in the nation's 225-year history.[5] In effect, the CBO had projected no significant correction of the stock market bubble that had built up over the previous three years. The projections also understandably failed to foresee the 2001 recession, the 2008 economic downturn, and income distributional shifts that dampened revenues.[6] The CBO would have been on firmer ground projecting revenue levels closer to the then-historical average of 18.4 percent of GDP.

The CBO also underestimated federal spending. It projected that spending across the decade would average 16.4 percent of GDP, even though Washington had not held spending that low in any year since 1951. Mandated by Congress to use archaic forecasting rules, the CBO projected that discretionary spending as a percentage of GDP would decline by 19 percent (including defense spending declining to 2.4 percent of GDP), and that no new entitlements would be created. Most implausibly, the projections assumed the publicly held debt would be effectively paid off by 2009, and the government would instead begin earning interest on its national surplus—new funds that expanded the budget surplus projections yet further.

Because this projected $5.6 trillion surplus assumed no economic slowdowns, no bursting stock market bubble, no 9/11 attacks, and no subsequent defense buildup, it was not possible for lawmakers to preserve that entire surplus once those events occurred. Of course, lawmakers did expand the burgeoning budget deficits by steeply increasing domestic spending and adding an expensive new entitlement to Medicare. And despite their positive economic impact, the 2001 and 2003 tax cuts also contributed to budget deficits (though much less than other factors).

In the seven years following that CBO report, revenues have averaged 2.7 percent of GDP below the inflated projections (with approximately 1 percent of GDP resulting from the tax cuts). Spending has averaged 3.3 percent of GDP above the projections (2.6 percent of GDP increase on programs and 0.7 percent of GDP increase on net interest). So even using those flawed numbers, the tax cuts are responsible for only one-fifth of the decline in America's net fiscal position relative to the famous $5.6 trillion budget surplus projection.[7]

Part 2: Debt Ratio Trends

The next three myths demonstrate how best to measure government debt, and examine past and future projected debt trends.

MYTH #4: The best way to measure a country's indebtedness is through annual budget deficits.

Fact: The debt ratio is of higher significance.

The heavy coverage of annual budget deficit dollar figures vastly outweighs their economic importance. To the extent that government debt is significant, cumulative publicly held debt as a percentage of the nation's income is the more relevant figure. After all, the total debt owed is much more significant than how much that debt increased over the past 12 months (which is what the deficit measures). Whether that debt level is manageable depends on total income; Bill Gates, for instance, could afford a much higher debt load than the typical American family. Hence, banks use the "debt ratio"—total debt as a percentage of income—to determine the level at which borrowing families and businesses can afford to owe.

The same common sense applies to measuring the federal government's finances. This year's projected $410 billion budget deficit merely shows the approximate annual change in the national debt. But that number reveals nothing about whether or not the debt burden is too high; nor does it show

5. Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2009,* pp. 24–25, Table 1.2.
6. The income distributional shifts occurred when the bulk of the income reductions in the early 2000s occurred among taxpayers in the higher tax brackets, thus accelerating the tax revenue decline.
7. Assigning proportional responsibility for the 0.7 percent in added net interest spending, the "cost" of the tax cuts rises from 1 percent of GDP to 1.2 percent of GDP. This is one-fifth of the combined 6 percent of GDP decline in America's net budget position relative to the CBO projections.

whether the overall debt burden is increasing or decreasing. Instead, the government's debt ratio—its publicly held debt as a percentage of GDP—is the superior variable when measuring the impact of the national debt on the American economy.

It is also worth noting why government debt is defined as publicly held debt, rather than total debt. The latter includes an additional $4.4 trillion in intergovernmental debt that federal agencies owe to each other (mostly what the Treasury Department owes the Social Security program after decades of raiding its trust fund to spend on other programs). This internal debt exists only on paper: It was never actually borrowed from the financial markets, and therefore does not the affect the current economy. Instead, it represents a future obligation of the federal government to raise taxes or reduce spending to repay the agency that loaned the money, which makes it a useful indicator of America's long-run financial condition. However, since it was not borrowed out of the current economy, intergovernmental debt is excluded from analyses of how the national debt affects the economy.

MYTH #5: The federal debt ratio is at record levels.

Fact: Economic growth has reduced the debt ratio below the historical average.

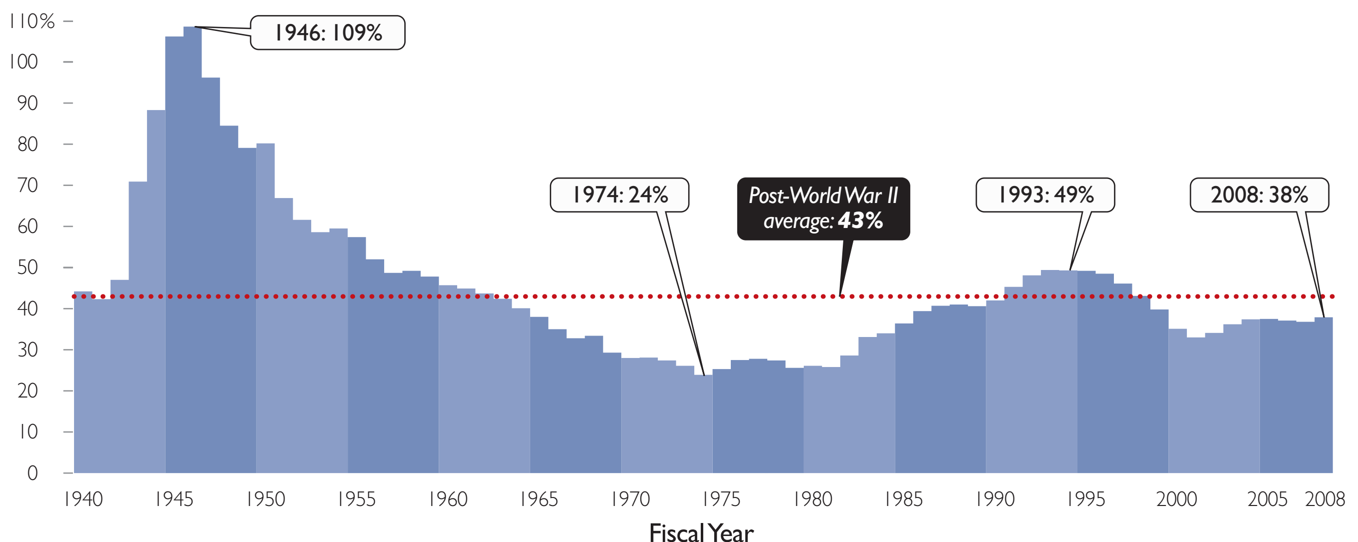
Chart 2 illustrates America's debt ratio since 1940. In 2008, America's $5.4 trillion public debt represents 38 percent of its $14.3 trillion GDP. Despite all the hand-wringing over increased budget deficits, the 38 percent debt ratio is *below* the post-World War II average of 43 percent. Consequently, America's debt burden is, in fact, low by historical standards.[8]

During World War II, The debt ratio surged from 40 percent to 109 percent, indicating that the nation's debt was larger than its annual GDP. The debt ratio fell back to 45 percent by 1960, and has since remained between 24 percent (in 1974) and 49 percent (in 1994).

There is no mystery to why the debt ratio has dropped so much since World War II: Economic growth has dwarfed the rate of new debt issuance. Since 1946, inflation-adjusted debt has grown by 114 percent, but the economy has grown by 532

The Federal Publicly Held Debt Is Slightly Below the Historical Average

Today's debt burden is also lower than it was in the booming late 1990s.



Source: Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2008), p. 320, Table B-79, at *http://www.gpoaccess.gov/eop/2008/2008_erp.pdf.*

Chart 2 • B 2178 heritage.org

percent—nearly five times as rapidly.[9] (See Chart 3.) Just as a family with rising income can afford to buy a more expensive home and accept more mortgage debt, the growing American economy has been able to absorb its new debt.

More recent debt ratio declines were also heavily influenced by economic growth. Since the debt ratio's recent 1994 peak, the public debt has expanded by 5 percent while the economy has grown by 40 percent. This has reduced the debt burden from 49 percent to 38 percent.[10] In fact, the current 38 percent debt ratio is below the ratio at any point during the 1990s. Thus, it is not surprising that recent budget deficits have not devastated the economy. As long as lawmakers promote pro-growth policies, modest debt is manageable.

A key lesson for lawmakers: Avoid debt-reduction strategies that would significantly reduce economic growth—thereby preventing significant debt ratio improvement. In particular, tax increases may reduce the nominal debt yet also slow economic growth. The better way to reduce the debt ratio is by combining pro-growth tax policies with spending restraint.

MYTH #6: The current debt levels can push us into economic calamity.

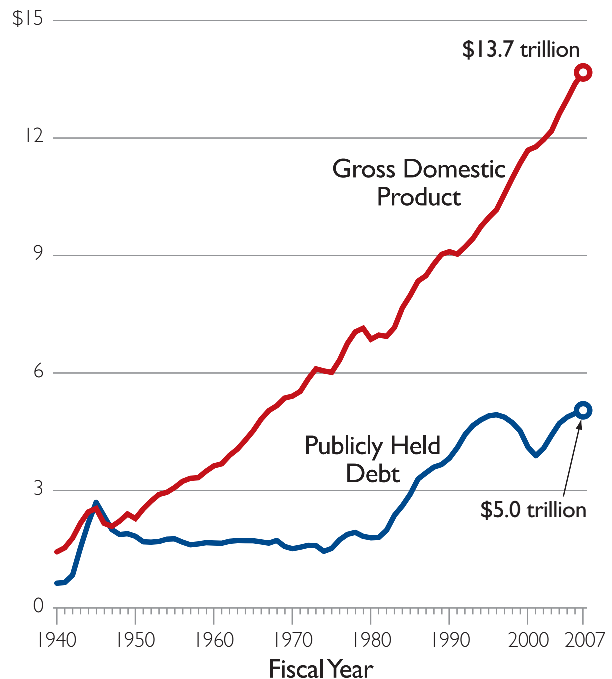
Fact: The real threat is the projected future debt from entitlement spending.

Over the past 50 years, the public debt has remained at manageable levels, below 50 percent of GDP. The current 38 percent debt ratio does not pose significant risks to the economy. More dangerous is the tsunami of debt coming from the enormous projected costs of paying Social Security, Medicare, and Medicaid benefits to 77 million retiring baby boomers. If lawmakers do nothing, those new expenses would be nearly entirely deficit-financed and—according to the Congressional Budget Office—drive the debt ratio to 292 percent by 2050, and 810 percent by 2080 (see Chart 4).[11]

Explained differently, today's public debt of $5.4 trillion should concern lawmakers less than the $42.9 trillion in unfunded Medicare and Social Security costs over the next 75 years.[12]

The Debt vs. The Economy

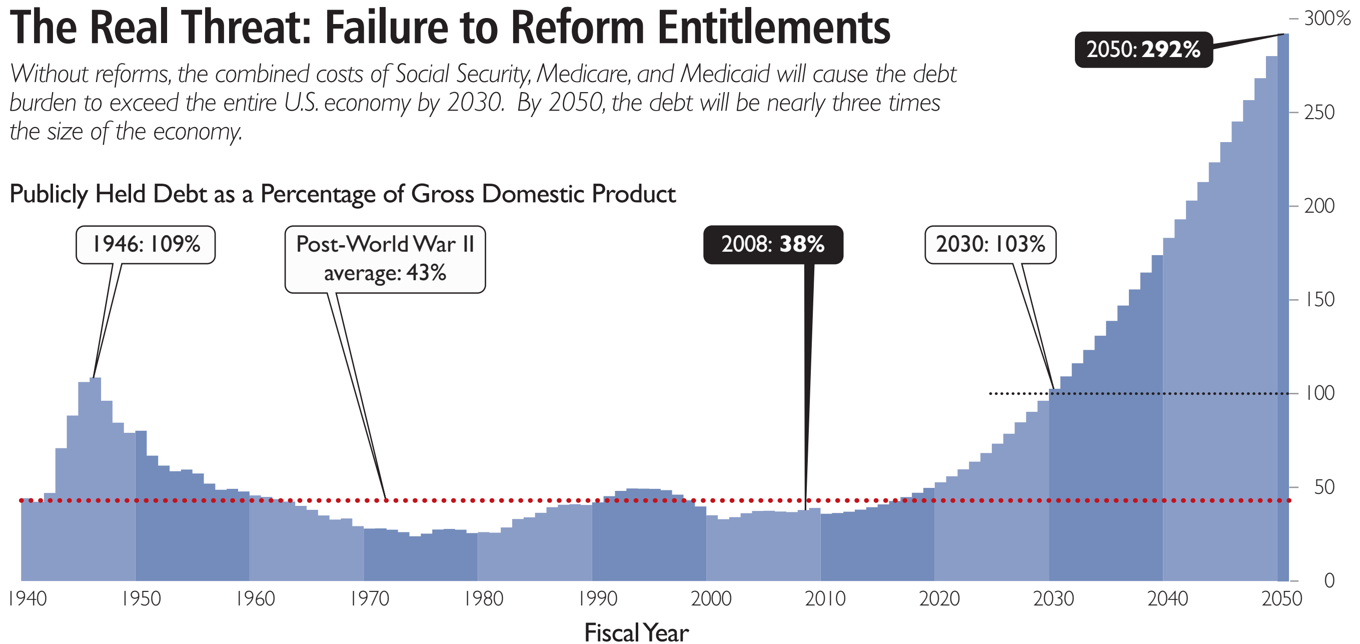
Although the federal debt has increased, the economy has expanded five times as rapidly.



Source: Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2008) Table B-78 (and adjusted for inflation), at *http://www.gpoaccess.gov/eop/2008/2008_erp.pdf.*

Chart 3 • B 2178 heritage.org

8. All debt ratio figures were calculated using data from the Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2008), p. 320, Table B-79, at *http://www.gpoaccess.gov/eop/2008/2008_erp.pdf* (September 1, 2008).
9. Council of Economic Advisers, *Economic Report of the President*, February 2008, Table B-78 (adjusted for inflation).
10. All post-1994 debt ratio reduction took place between 1994 and 2001, when it fell to 33 percent. Since 2001, the debt has grown slightly faster than the economy, pushing the debt ratio back up to 38 percent—still below the 1990s levels.
11. Congressional Budget Office, *The Long-Term Budget Outlook*, December 2007, p. 5, at *http://www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf* (September 1, 2008). This represents the alternative fiscal scenario.



Source: Congressional Budget Office, *The Long-Term Budget Outlook*, December 2007, p. 5, at *www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf*. This represents the alternative fiscal scenario.

Chart 4 • B 2178 heritage.org

Such enormous debt levels would be economically catastrophic (as explained in the next section). Of course, the alternatives of financing those entitlement costs by a) raising taxes by the current equivalent of $12,000 per household, or b) eliminating all remaining federal programs are not plausible either.[13] Reforming and modernizing Social Security, Medicare, and Medicaid is the only way to avoid choosing between these painful scenarios.

Part 3: Does Government Debt Matter?

The final four myths explain which of the traditional arguments against government debt are valid and which are overrated.

MYTH #7: The national debt is raising interest rates significantly.

Fact: The current debt ratio is too small to have enough impact on interest rates.

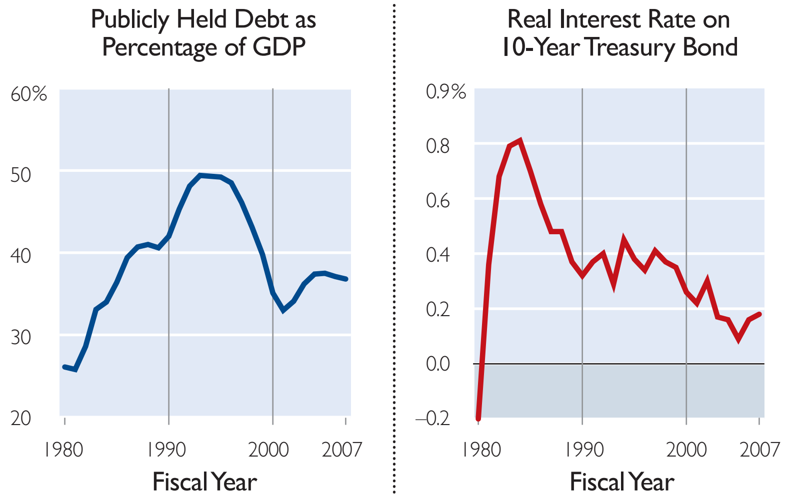
The most commonly cited argument against budget deficits is that they substantially raise interest rates, but the numbers tell a different story. Since 2000, the $236 billion budget surplus has been replaced by an estimated $410 billion budget deficit.[14] However, instead of rising, the real interest rate on the 10-year Treasury bond has *dropped* from 2.6 percent to 1.8 percent.[15] (See Chart 5.)

12. David C. John and Robert E. Moffit, "Medicare and Social Security: The Challenge of Giant Entitlement Costs," Heritage Foundation *WebMemo* No. 1867, March 25, 2008, at *http://www.heritage.org/Research/Budget/wm1867.cfm*.
13. Brian M. Riedl, "A Guide to Fixing Social Security, Medicare, and Medicaid," Heritage Foundation *Backgrounder* No. 2114, March 11, 2008, at *http://www.heritage.org/Research/Budget/bg2114.cfm*.
14. Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2009*, pp. 21–23, Table 1.1.
15. Council of Economic Advisers, *Economic Report of the President*, p. 312, Table B-73 (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. In 2000–2007, the nominal interest rate dropped from 6.0 percent to 4.6 percent.

The first and most obvious reason for this disconnect is the erroneous focus on the budget deficit rather than the debt ratio. While the $646 billion swing of budget surpluses to deficits seems very large, the debt ratio has barely budged, rising from 35 percent to 38 percent.

The second issue is to what extent an increasing debt ratio really raises interest rates. In theory, higher demand for a good or service will cause prices to rise. 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 the amount 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 Washington's borrowing without triggering a substantial increase in interest rates.



Note: Interest rates are adjusted for inflation.

Source: Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2008), pp. 312 and 320, Tables B-73 and B-79.

Chart 5 • B 2178 heritage.org

Harvard economist Robert Barro[16] studied the economies of 12 major industrialized countries and found that:

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 are more significant 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.

In other words, raising interest rates by just 1 percentage point would require all 12 nations to raise their debt ratios by a full 10 percentage points. If just the United States raised its debt ratio, the effect on interest rates would be much smaller. 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.

Similar to Barro, research by the American Enterprise Institute's Eric Engen and Columbia University economist and former Chairman of the Council of Economic Advisers Glenn Hubbard estimates that a 1 percentage point increase in the U.S. debt ratio increases long-term interest rates by approximately 0.035 percent. Using these calculations, it would take a 29 percentage point increase in the U.S. debt ratio—totaling $4.1 trillion in new debt—to raise long-term interest rates by just 1 percentage point.[17]

16. Robert Barro, "Have No Fear: Bush Tax Plan Won't Jack Up Interest Rates," *Business Week*, May 5, 2003.

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MYTH #8: Growing foreign ownership of the debt is significantly harming the economy.

Fact: While not without risks, it has held interest rates down thus far.

Excluding the portion owned by the federal government, ownership of the federal debt is split about equally between Americans and foreigners. For American debt holders, such as individuals, banks, insurance funds, pension funds, mutual funds, and state and local governments, U.S. bonds and Treasury bills offer a safe, albeit low-return, investment. Since 1996, the portion of the debt owned by foreign governments, individuals, and companies has increased from one-quarter to one-half, led by Japan (holder of 12 percent of the total public debt) and China (10 percent). No other foreign country owns more than 4 percent of the total public debt.[18]

Foreign purchases of U.S. government debt have some advantages. Most important, they reduce the need for Washington to dip into the domestic savings pool, thus alleviating the risk of higher interest rates and reduced domestic funds available for private investment.

One concern, however, is that an increasing portion of the foreign debt is being purchased by foreign governments rather than private foreign investors (specifically, central banks in Japan, China, Taiwan, South Korea, and India). While the debt purchases of profit-motivated foreign investors are generally predictable, foreign central banks' purchases may be motivated by macroeconomic purposes, such as stabilizing their exchange rates, or by non-economic geo-political considerations. If these central banks change their strategies and stop purchasing U.S. government debt, the effect could be large enough to raise interest rates in the United States.[19]

MYTH #9: Net interest costs are growing.

Fact: Low interest rates have held them down.

While the interest rate and foreign ownership ramifications are probably overrated, the largest danger posed by rising debt is that it represents a claim on future taxes. In 2008, interest on the federal debt is projected to cost taxpayers $234 billion—$2,090 per household.[20] This is certainly a lot of money; only Social Security, Medicare, and defense spending cost more to the federal government annually. Without net interest costs, the 2007 budget would have been balanced.

Net interest costs have been falling, however. The portion of the federal budget consumed by net interest costs has dropped from 10 to 15 percent of annual federal spending during the 1980s and 1990s, to 8 percent today.[21] Low interest rates have more than compensated for rising debt levels since 2001. If interest rates begin rising, however, net interest costs will follow.

Net interest costs represent the most significant downside to the federal debt (see Chart 6). They force Washington to choose between higher tax rates and less program spending (or even more debt). As stated earlier, if lawmakers allow Social Security, Medicare, and Medicaid spending to push the debt anywhere near the future projected levels, net interest costs would overwhelm the budget. In fact, Washington would have to borrow so much money that interest rates would rise significantly, thus necessitating more government borrowing and triggering an economically calamitous vicious circle of growing federal debt and interest rates.[22]

Overall, reduced net interest costs on the federal budget would be the best result of a reduced government debt.

17. Eric M. Engen and R. Glenn Hubbard, "Federal Government Debt and Interest Rates," American Enterprise Institute *Working Paper* No. 105, June 2, 2004, p. 1, at *http://www.aei.org/docLib/20040825_wp105.pdf* (September 1, 2008).
18. United States Department of the Treasury, "Introduction: Ownership of Federal Securities," pp. 36–37, Table OFS-2, at *http://www.fms.treas.gov/bulletin/b2008-2ofs.doc*, and United States Department of the Treasury, "Major Foreign Holders of Treasury Securities" (last updated June 2008), at *http://www.treas.gov/tic/mfh.txt* (September 1, 2008).
19. Justin Murray and Marc Labonte, "Foreign Holdings of Federal Debt," Library of Congress, Congressional Research Service, Report No. RS22331, November 28, 2005.
20. Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2009*, p. 44.
21. Calculated by The Heritage Foundation using figures from the Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2009*, pp. 56–73, Table 3.2.

The Real Cost of Government Debt

How net interest costs from the debt compare to selected program budgets in 2008:

Program	Cost in Billions
Net Interest	$243.9
Income Security Programs	234.1
Medicaid	203.8
Veterans Benefits	86.6
Health Research and Regulation	80.7
Education	67.5
Highways and Mass Transit	53.1
Justice Administration	46.2
Unemployment Benefits	37.3
Natural Resources and Environment	35.5

Source: Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2009* (Washington, D.C.: U.S. Government Printing Office, 2008), pp. 56–73, Table 3.2 (outlays), at *www.whitehouse.gov/omb/budget/fy2009/pdf/hist.pdf.*

Chart 6 • B 2178 heritage.org

MYTH #10: Debt reduction should be the goal of budget policy.

Fact: Debt can sometimes be helpful, or at least benign.

Debt can be justified for emergencies as well as for long-term investments. Families can justify going into debt for investments such as buying a home and attending college, as well as emergencies like serious injuries and illness. At the same time, using debt for basic consumption expenditures such as vacations and electronics is not recommended.

The same holds true for government. Few would argue that World War II was not a justifiable reason to go deeply into debt. And any pro-growth fiscal policies (including tax rate reductions) may justify debt if they are likely to increase long-term productivity and wealth—which is not only one of the chief goals of economic policy, it may also reduce the debt ratio later by raising economic growth. However, government debt is far less justified for non-emergencies and non-growth policies.

Temporary debt can sometimes lead to long-term savings. For example, it is plausible that the 1980s debt contributed to the late 1990s surpluses. The expensive defense buildup under President Reagan played a central role in the 1991 collapse of the Soviet Union and subsequent 1990s defense savings. Similarly, the large Reagan tax-rate reductions immediately lowered revenues during the early 1980s, but also helped inaugurate the strongest 25-year period in American economic history, which clearly benefited later federal budgets. Lawmakers should examine each debt-increasing proposal on a case-by-case basis and determine whether the policy responds to an emergency or represents an investment with sufficient long-term payoff.

Policy Lessons

Three policy lessons can be drawn from these myths and facts:

1. **Economic growth reduces the debt burden.** There are two ways to reduce the debt ratio: budget surpluses and economic growth. When contemplating budget surpluses, lawmakers should be wary of choosing tax increases over spending cuts. While tax increases may reduce nominal debt levels, they may also reduce economic growth enough to leave the debt ratio unchanged or higher. In that instance, Americans risk sacrificing their tax dollars and strong 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 therefore reduces the debt burden. With corporate welfare, pork-barrel projects, obsolete pro-

22. See Congressional Budget Office, "The Long-Term Economic Effects of Some Alternative Budget Policies," letter to the Honorable Paul Ryan, May 19, 2008, at *http://www.cbo.gov/ftpdocs/92xx/doc9216/Letter-to-Ryan.1.1.shtml* (September 1, 2008).

grams, and waste totaling hundreds of billions of dollars annually, lawmakers have little excuse for not streamlining spending.

2. **Interest costs are the main drawback of debt.** At 38 percent of GDP, current federal debt levels are not large enough to significantly raise interest rates. Nor has increased foreign ownership of the federal debt proved demonstrable harm to economic growth. Rather, the federal debt's main drawback is the $234 billion in annual net interest costs that forces lawmakers to maintain higher tax rates, low program spending levels, and/or higher budget deficits than otherwise. The main benefit from a reduced debt ratio would be lower net interest costs in the federal budget.
3. **The future debt is the concern.** The current debt ratio is below not only the post-World War II average, it is also lower than at any point in the 1990s. Today's debt levels are sustainable, but projected future levels are not. The coming tsunami of costs from Social Security, Medicare, and Medicaid benefits to 77 million retiring baby boomers threatens to push the debt ratio up to nearly 300 percent by 2050—an economically catastrophic level. Today's $5.4 trillion public debt is much less important than the $42.9 trillion in unfunded Medicare and Social Security costs over the next 75 years. Lawmakers must reform these entitlement programs to avoid this level of debt.

Conclusion

Despite concerns about "record budget deficits," recent economic growth has allowed the debt ratio to remain below the historical average. The danger of debt is that it brings net interest costs today, and represents a claim on future taxes. Streamlining wasteful spending while also pursuing a pro-growth tax policy is the best way to keep the debt ratio at a manageable level and maintain economic prosperity.

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