A GUIDE TO THE FEDERAL BUDGET DEFICIT AND NATIONAL DEBT

MANY ECONOMISTS WARN THAT THE UNITED STATES WILL LIKELY FACE AN ECONOMIC CATASTROPHE IN A FEW DECADES UNLESS IT SLOWS THE NATIONAL DEBT'S GROWTH. TO DO THIS, THE FEDERAL GOVERNMENT NEEDS TO CUT ITS TRILLION-DOLLAR ANNUAL BUDGET DEFICIT.

1. What are the federal budget deficit and national debt?

A **budget deficit** occurs when the government spends more than it collects in taxes and other income during a fiscal year. (The federal government's fiscal year is Oct. 1–Sept. 30.) In 2011, the federal budget deficit is projected to reach $1.5 trillion. That is $1,500,000,000,000.

Whenever the federal government runs a deficit, it has to borrow money to pay for its excess spending. Most often, the Federal Reserve, the nation's central bank, auctions U.S. Treasury securities (bills, notes, and bonds) to investors willing to lend the government money. They will earn interest on the securities they buy.

The **national debt** is the total amount the government owes from its borrowing. The total is currently about $13.8 trillion. The national debt has two parts: **public debt** and obligations. The public debt consists of Treasury securities held by investors outside the federal government. It currently is about $9 trillion of the $13.8 trillion total debt.

Americans hold half of the Treasury securities that make up the U.S. public debt. Foreign investors, including governments, hold the other half. China has purchased nearly $1 trillion in U.S. Treasury securities, the most held by any foreign country.

The **obligations** part of the national debt consists of debts the government owes to itself. For example, the federal government has borrowed from the Social Security Trust Fund and given it Treasury securities. Such internal government obligations make up the rest of the national debt.

2. How is the national debt related to Gross Domestic Product?

One way to measure the growth of a nation's debt is to calculate its percentage of the Gross Domestic Product, or GDP. The GDP is the value of all the goods and services produced by a country in one year. The U.S.'s GDP for 2010 was $13.3 trillion (adjusted for inflation). By this measure, the public debt, all those Treasury securities held by Americans and foreigners, amounted to about 62 percent of GDP (expressed as 62%/GDP) in 2010. Economists are not sure at what percentage of GDP the public debt would create an economic crisis. A clear warning sign would be 100%/GDP.

3. How much is the national debt likely to grow if we do not control it?

Established in 1971, the Congressional Budget Office (CBO) provides an independent evaluation of federal budget matters. In January 2011, the CBO made its "baseline" projection of the budget deficit and public debt. This projection assumes current budget laws remain in place. For example, it assumes that scheduled spending cuts will take place and that tax cuts scheduled to expire will do so.

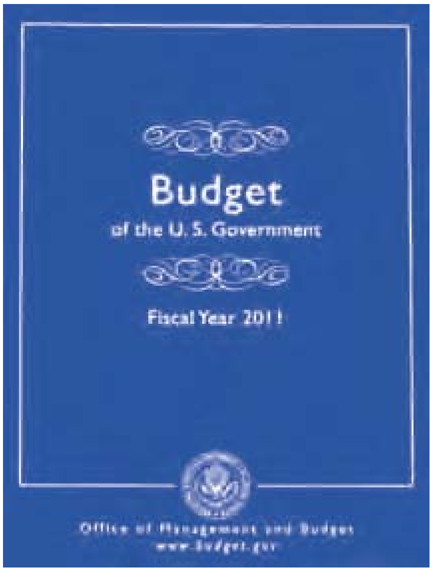
Based on this assumption, CBO projects budget deficits will "drop markedly" from about $1.5 trillion in 2011 to $533 billion in 2014. But increasing costs of entitlements (such as Medicare) will again force deficits to increase to $763 billion and the public debt to 77%/GDP by 2021 and ever higher after that.

If Congress renews the tax cuts and fails to make the scheduled spending cuts, then the CBO projection gets much worse. Federal revenues would decrease and expenditures would rise, and the public debt would reach 97%/GDP in 2021.

4. How did we get such a large debt?

Throughout most of U.S. history, the federal government maintained balanced budgets (no deficit spending) and moderate debt except during wars and times of economic crisis. After World War II, the U.S. had a public debt of 108%/GDP, the highest public debt to GDP ratio ever reached by the country.

Following the war, the economy prospered, although it did occasionally go into recession. Presidents ➤



Truman and Eisenhower adopted the policy of balancing the budget over the course of the business cycle. This meant running deficit budgets during recessions when tax revenues declined and balancing the budget or running a surplus when revenues increased as prosperity returned.

Defense spending surged to 56 percent of the federal budget in the 1950s as Cold War tensions with the Soviet Union intensified. Federal spending at home, however, remained stable. President Eisenhower favored tax cuts, but only if the debt was being reduced. At the end of his presidency in 1960, the public debt had been cut to below 50%/GDP.

The debt-to-GDP ratio continued dropping and hovered around 25 percent until the 1980s. During the Reagan administration, Congress cut taxes and sharply increased Cold War defense spending, which produced large budget deficits. Later in the Reagan administration, Congress raised taxes to try to control deficit spending, but the debt-to-GDP ratio had risen to 41 percent.

During the administration of President George H. W. Bush, Congress increased taxes and reduced deficit spending to slow the growth of the public debt. In the Clinton administration, Congress further reduced spending and increased taxes to achieve budget surpluses. This resulted in stabilizing the public debt at about 35%/GDP.

When George W. Bush became president in 2001, Congress cut taxes and secured a new Medicare drug benefit for seniors. The country also went to war in Afghanistan and Iraq. The loss of tax revenue plus the additional spending plunged the federal budgets back into deficit and more public debt, which increased to 40%/GDP by 2008.

Then the "Great Recession" hit the economy. President Bush and Congress responded with $168 billion in government spending to stimulate the economy. The stimulus spending and government programs to aid banks and other financial institutions further added to the federal budget deficit and public debt. By the time President Bush left office in January 2009, the public debt was approaching 50%/GDP.

President Barack Obama continued Bush's anti-recession spending policies. Congress also passed a new $814 billion stimulus program of tax cuts and government spending, the largest in U.S. history. The combined budget deficits under the Bush and Obama administrations increased the public debt from $3.3 trillion in 2001 to about $9 trillion or 62%/GDP by the end of 2010.

Late in 2010, President Obama and Republicans in Congress agreed on a tax reduction deal to stimulate the economy. This included renewing the Bush administration tax cuts for all income levels for two years. In addition, the deal enacted two-year reductions on the estate (inheritance) tax, investment taxes, and the Social Security payroll tax. The deal also continued other tax breaks and extended unemployment benefits for 13 months. This package may add nearly $1 trillion to the public debt over the next two years. Supporters, however, are hoping that the tax cuts and unemployment benefits will help stimulate the economy and actually increase federal revenues.

One piece of good news in the recent era of federal deficit budgets and soaring debt is that the U.S. is paying historic low interest on the Treasury securities it auctions to investors. The low interest rates reflect the current view of lenders that the U.S. is still a safe bet for investing their money.

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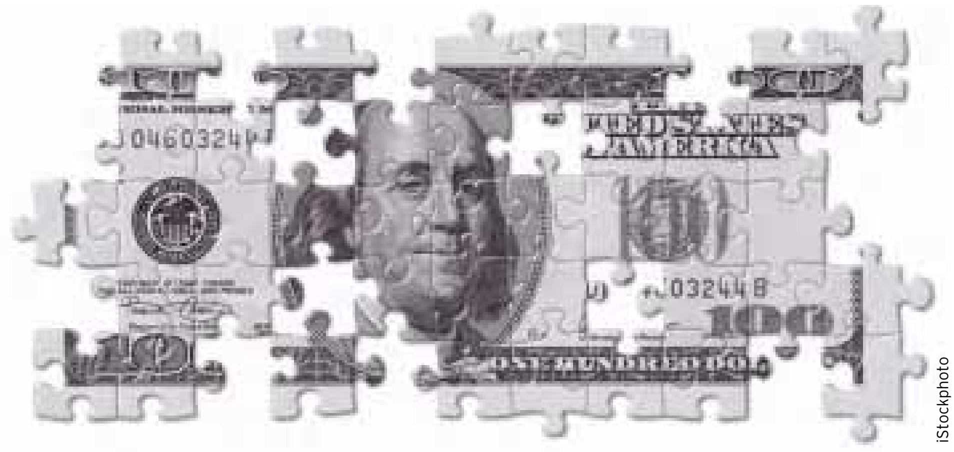
THE U.S. CONSTITUTION requires that any bill raising revenue must originate in the House of Representatives.

5. What will happen if we do not fix the deficit and debt problem?

This question arouses much debate among economists, politicians, and others. Some economists believe the following is likely to happen if large federal budget deficits continue to cause the public debt to soar over the next few decades: The U.S. public debt-to-GDP ratio may reach a "tipping point" when investors decide the U.S. is no longer a safe bet to pay off what it owes. They may demand very high interest for Treasury securities, or they may refuse to buy them at all. As a condition for lending any more money, investors may force the government to impose crushing taxes and adopt drastic spending cuts on everything from defense to Social Security pensions. Runaway inflation may result if the U.S. tries to pay its public debt by printing money or reducing the dollar's value. In this scenario, families and businesses will suffer from high interest on borrowing, high prices, high taxes, wage cuts, business failures, high unemployment, and severe cuts in all government services.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6. How can we reduce the deficit and debt?

One answer is to deal with the budget: Cut spending, raise taxes, or do a combination of the two. But trying to do any of these things provokes great political controversy. Many Americans oppose raising taxes, and most Republicans have promised never to raise taxes. A lot of Americans also oppose cutting spending on popular programs. Many Democrats have pledged never to cut Social Security or Medicare. A political battle line has formed, and it makes cutting spending or raising taxes difficult to achieve.

Another answer is to grow the economy. Economic growth will produce more tax revenue, which could then be used to reduce the deficit and slow the growth of the debt. A 1 percent increase in economic growth over 10 years could increase federal tax revenues by $2.5 trillion in that period. (It would also lower the debt-to-GDP ratio.)

But how to grow the economy also stirs controversy. President Obama calls for more government spending for education, research in such areas as electric car batteries, and improvements in infrastructure (highways, bridges, high-speed trains). Conservatives argue economic growth will take off when investment and business tax rates are reduced, the Bush administration tax cuts are made permanent, and regulations on businesses are removed.

7. What cuts in federal spending could be made to reduce the deficit and debt?

Discretionary spending is the amount in the federal budget that Congress and the president decide on each year. One target for cuts in discretionary spending is defense, which makes up 20 percent of the federal budget. Defense spending is currently about $700 billion a year, an amount far higher than any other country. In fact, it equals the combined amount spent on defense by every other country in the world.

About $160 billion of defense spending goes for the wars in Afghanistan and Iraq. Other costs include military personnel, machinery (ships, aircraft, missiles, nuclear weapons), and bases around the world.

Another 20 percent of the federal budget consists of non-defense discretionary spending. Current popular proposals to cut discretionary spending such as freezing federal worker pay and eliminating "earmarks" (projects sponsored by members of Congress) add up to only a tiny fraction of discretionary spending.

Most non-defense discretionary spending is for services to the public provided by federal departments, agencies, and programs. These include the federal courts and prisons, national parks, foreign diplomacy, environmental protection, disaster relief, aid to schools and colleges, aid to the arts, the space program, food safety, medical research, highway construction, and many others.

The biggest targets for reducing the budget deficit are **entitlements**, which are government benefits and payments set by law. The major entitlement programs are Social Security, Medicare, and Medicaid (health care for the poor). Other entitlements include veterans' benefits, child health care, unemployment insurance, the welfare to work program, and food stamps. Entitlement spending accounts for over half of the federal budget.

Among all the entitlements, Medicare's cost ($468 billion in 2010) is increasing the fastest. A large part of our population is growing older and living longer. Medicare accounts for about 15 percent of all federal spending.

An analysis by Congressional Budget Office projects that Medicare spending cuts and taxes in the new Obama health-care law would reduce the deficit by $230 billion over 10 years. (Some economists have challenged this projection and argue the health-care law will add to the deficit.) Others propose replacing Medicare with a less costly grant to seniors to buy health coverage from competitive private insurance companies.

At present, Social Security payments do not add to the national debt. The payroll tax deducted from most worker paychecks has more than covered this entitlement. The Social Security Trust Fund also holds

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Treasury securities that the U.S. is obligated to pay off with interest.

Fewer younger workers, however, now pay into the Social Security system relative to the growing number of older retired workers who are collecting benefits. Unless this problem is fixed, the government will have to make cuts in Social Security benefits, raise payroll taxes, increase the retirement age, or fund them with public debt.

8. What federal taxes could be increased or created to raise more revenue for deficit and debt reduction?

In addition to spending cuts, tax increases or new taxes can also help reduce the budget deficit and slow the public debt's growth. Relative to the Gross Domestic Product (GDP), federal tax revenues are at the lowest level since 1950.

All of the following proposals draw great controversy. Critics argue that they will slow, or perhaps even derail, the economy.

The tax cuts under President Bush reduced federal revenue, pumped up the budget deficit, and added to the public debt. Ending these tax cuts would contribute trillions of dollars to deficit and debt reduction over a 10-year period.

With the top 1 percent of U.S. income earners enjoying tax rates that are one-third lower than they were in 1970, some are proposing a special "millionaire's tax" on annual income above $1 million. A number of states are already collecting such a tax on the rich to help close their budget deficits.

In addition, raising estate and financial investment (capital gains and dividends) taxes back to what they were under President Clinton would reduce the budget deficit by billions of dollars each year.

Some have proposed new taxes such as a temporary national sales tax dedicated to deficit reduction.

Some have proposed new taxes such as a temporary national sales tax dedicated to deficit reduction. Making taxable the health insurance benefit provided by a worker's employer would add $3 trillion in new tax revenue between 2012 and 2030.

Another way to raise tax revenue would be to eliminate "tax expenditures." These are all the credits, deductions, exemptions, and other tax breaks for individuals and businesses that reduce the federal taxes they owe each year. For example, Americans took $131 billion in mortgage interest deductions in 2010.

9. What are the recommendations of the National Commission on deficits and the debt?

In 2010, President Obama appointed the bipartisan National Commission on Fiscal Responsibility and Reform to study and make recommendations on reducing the deficit and national debt. The majority of the National Commission members agreed on a plan, consisting of 75 percent spending cuts and 25 percent tax increases, to solve the nation's deficit and debt problem.

The National Commission majority submitted recommendations that would cut the budget deficit by $4 trillion through 2020 and reduce the public debt to 30%/GDP by 2040. Among its list of guiding principles, the majority cautioned against acting too quickly, which might undermine the recession recovery.

The section below summarizes the key recommendations made by the National Commission majority:

Defense and Non-Defense Discretionary Cuts and Savings

- In 2013, return discretionary spending to 2008 pre-recession levels.
- All discretionary defense spending, except for current wars, should be subject to cuts and savings.
- Non-defense discretionary spending cuts should include a 10 percent reduction in the federal workforce, a federal worker pay freeze, and savings in all federal programs.

Health Care Entitlement Cuts and Savings

- Cut the cost of Medicare payments to doctors by paying them based on the quality instead of the quantity of the services they provide.
- Require an annual $550 deductible for Medicare patients that they must pay for services before Medicare picks up the cost.
- Enact medical malpractice lawsuit reform that limits money claims for damages caused by doctors.
- Starting in 2020, put a limit on total federal healthcare spending growth.
- Review possible increases in the share paid by federal workers, military personnel, and veterans for their health-care programs.

Social Security Entitlement Cuts and Savings

- Raise the age for full retirement benefits from 66 to 68 in 2050 and 69 in 2075. Provide a hardship exemption for those who are physically unable to work past 62.
- In 2020, increase to $190,000 the maximum taxable wage subject to the Social Security payroll tax to collect more revenue. (The current maximum wage subject to the Social Security payroll tax is $106,800.)

Tax Increases and Reforms

- Reduce or eliminate all credits, deductions, exemptions, and other "tax expenditures" for individuals and businesses. For example, limit the home mortgage interest deduction to a family's primary residence.
- Make all capital gains and dividend investment income taxable at the regular income tax rate instead of the current lower 15 percent rate.
- Increase the federal gasoline tax by 15 cents a gallon to pay for federal transportation and highway construction costs.
- Tax increases such as those listed above would cut the deficit and make it possible to reduce income and corporate tax rates, which would encourage economic growth.

Standards Addressed

WPA

National High School U.S. History Standard 24: Understands how the New Deal addressed the Great Depression, transformed American federalism, and initiated the welfare state. (1) Understands the first and second New Deals (e.g., the success of the relief, recovery, and reform measures associated with each). (5) Understands the significance and ideology of FDR and the New Deal (e.g., whether the New Deal was able to solve problems of depression...).

California History-Social Science Standard 11.6: Students analyze the different explanations for the Great Depression and how the New Deal fundamentally changed the role of the federal government. (4) Analyze the effects of and the controversies arising from the New Deal economic policies and the expanded role of the federal government in society and the economy since the 1930s (e.g., Works Progress Administration...).

National Debt

National High School U.S. History Standard 31: Understands economic, social, and cultural developments in the contemporary United States. (5) Understands major contemporary social issues and the groups involved....

National High School Economics Standard 6: Understands the roles government plays in the United States economy. (2) Understands that most federal tax revenue comes from personal income and payroll taxes and these taxes are used to fund social security payments, the costs of national defense, medical expenditures, and interest payments on the national debt.

National High School Economics Standard 8: Understands basic concepts of United States fiscal policy and monetary policy. (2) Understands the concepts of balanced budget, budget deficit, and budget surplus. (3) Understands that when the government runs a budget deficit, it must borrow from individuals, corporations, or financial institutions to finance the excess of expenditures over tax revenues. (4) Knows that the national debt is the total amount of money that the government has borrowed over all the years it ran deficits that have not been repaid.

California History-Social Science Standard 11.11: Students analyze the major social problems and domestic policy issues in contemporary American society.

California History-Social Science Standard 12.3e: Students analyze the influence of the federal government on the American economy. (3) Describe the aims of government fiscal policies (taxation, borrowing, spending) and their influence on production, employment, and price levels.

Tulipmania

National High School World History Standard 27: Understands how European society experienced political, economic, and cultural transformation in an age of global intercommunication between 1450 and 1750. (10) Understands factors that influenced the economic and political development of the Dutch Republic... (e.g., characteristics of the Dutch Republic that affected commerce and religion, and enabled Amsterdam to gain commercial supremacy over the northern Italian city-states in the late 16th century....

National High School Economics Standard 3: Understands the concept of prices and the interaction of supply and demand in a market economy. (3) Understands that changes in supply or demand cause relative prices to change; in turn, buyers and sellers adjust their purchase and sales decisions.

California History-Social Science Standard 7.11: Students analyze political and economic change in the sixteenth, seventeenth, and eighteenth centuries (the Age of Exploration, the Enlightenment, and the Age of Reason). (3) Examine the origins of modern capitalism;... the elements and importance of market economy in seventeenth-century Europe; the changing international trading and marketing patterns....

California History-Social Science Standard 12.2e: Students analyze the elements of America's market economy in a global setting. (2) Discuss the effects of changes in supply and demand on the relative scarcity, price, and quantity of particular products. (8) Explain the role of profit as the incentive to entrepreneurs in a market economy.

About Constitutional Rights Foundation

Constitutional Rights Foundation is a non-profit, non-partisan educational organization committed to helping our nation's young people to become active citizens and to understand the rule of law, the legal process, and their constitutional heritage.

Established in 1962, CRF is guided by a dedicated board of directors drawn from the worlds of law, business, government, education, and the media. CRF's program areas include the California State Mock Trial, youth internship programs, youth leadership and civic participation programs, youth conferences, teacher professional development, and publications and curriculum materials.

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10. What was the reaction to these recommendations?

Liberals charged that the National Commission relied too much on spending cuts and too little on taxing the rich, who benefited most from the Bush tax cuts. They also warned against slashing government spending when the country needs additional federal economic stimulus and help for 15 million jobless Americans.

Conservatives objected to the tax increases recommended by the National Commission. They believe increasing taxes will slow economic growth. They argued that major cuts in mostly non-defense discretionary spending and tax cuts to stimulate economic growth are the solutions to the debt problem.

Some liberals and conservatives warn against taking immediate action on cutting the deficit. They believe it could trigger another recession. They want to focus on growing the economy. More growth means more tax revenue to decrease the deficit and debt. But their prescriptions for growing the economy differ. Conservatives want further tax cuts across the board. Liberals want to invest heavily in education, job retraining, and infrastructure and to lower taxes for those with low incomes. These prescriptions, however, would require increasing the deficit and debt in the short run.

FOR DISCUSSION AND WRITING

1. Why should Americans worry about the growing national debt?

2. What are the differences between "discretionary" and "entitlement" spending? Which kind of spending do you think would be hardest for Congress and the president to cut? Why?

3. Which one of the National Commission's recommendations do you like the most and which one the least? Why?

ACTIVITY

How Would You Solve the Federal Deficit and Debt Problem?

A. Students should first individually answer the three questions listed below.

B. Students should then meet in small groups to discuss their answers and try to reach agreement on them.

C. Each group should report to the class the result of its discussion.

D. As an extended activity, students can make specific spending and tax choices to try to solve the deficit and debt problem by doing one or both of the online budget simulations linked to on the CRFBlog at: http://crfblog.org/?p=1985

Questions for Individual Response and Discussion

1. Review question 10 in the article. What approach do you think the U.S. should take in fixing the deficit and debt problem? (Check one.)

   - ☐ cuts in federal spending alone
   - ☐ increases in existing taxes and new taxes alone
   - ☐ a combination of spending cuts and tax increases; state a percent for each:
     spending cuts _____%
     tax increases _____%
   - ☐ a combination of spending cuts and tax cuts
   - ☐ delay major deficit and debt reduction and increase federal spending for investment in economic growth (e.g., education, job retraining, infrastructure)
   - ☐ delay major deficit and debt reduction and reduce taxes on all Americans.

2. Review question 7 in the article. Rank the following federal spending targets 1–4 from the target you think should be cut the most (1) to the one you think should be cut the least (4). The percentages indicate approximate share of the federal budget.

   __defense discretionary spending (20%)

   __non-defense discretionary spending (20%)

   __Social Security, Medicare, and Medicaid entitlement spending (40%)

   __other entitlement spending (14%)

   (The remaining 6% is for required interest payments on the public debt.)

3. Review question 8 in the article. Check any of the following tax policies below with which you agree.

   - ☐ cancel all the Bush tax cuts
   - ☐ cancel the Bush tax cuts for only those with incomes over $250,000
   - ☐ raise the estate tax rate for inheritances over $1 million
   - ☐ raise capital gains and dividend (investment) tax rates
   - ☐ impose a special tax on annual incomes above $1 million
   - ☐ enact a 6% national sales tax for deficit reduction only
   - ☐ eliminate all tax deductions and other "tax expenditures" for individuals and businesses
   - ☐ no tax increases and no new taxes