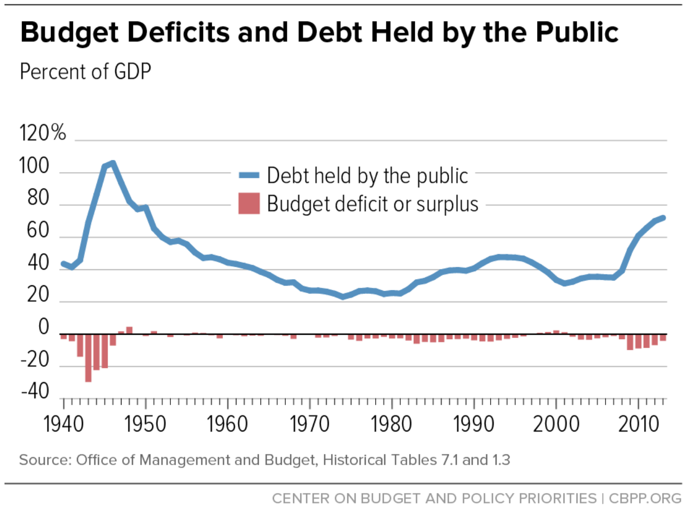
Deficits, Surpluses and the Public Debt



Definitions of deficit, surplus and debt

- A budget deficit is the amount by which government's expenditures exceed its revenues during a particular year.In contrast, a surplus is the amount by which its revenues exceed expenditures.
  - In 1997 there was a Federal deficit of $22 billion.
  - In 1999 there was a surplus of $125 billion.
- The national or public debt is the total accumulation of the Federal government's total deficits and surpluses that have occurred through time.State and local governments historically have a collective budget surplus.

Three Budget Philosophies

- The annually balanced budget was the goal until the 1930s Depression, but this ruled out using fiscal policy as a countercyclical, stabilizing force and even makes recession or depression worse.
  - The balanced budget is not neutral, but is procyclical, that is, it worsens the business cycle.
  - In a recession, the government would have to raise taxes and lower spending to balance the budget as tax revenues fell with recessionary income levels.This policy would worsen recession.
  - In an inflationary boom period, a balanced budget would intensify the inflation.As tax revenues increased, the government would need to cut taxes or raise spending to avoid a budget surplus.This strategy would make the inflation worse.
  - Those who argue for the annually balanced budget want to limit the growth of government.

- The cyclically balanced budget is a spending philosophy which allows for some government stabilization policy over the length of the business cycle.Deficit spending is allowed during a recession, and surpluses during an inflationary period.Over the business cycle, deficits would be offset by surpluses.But in reality, surpluses and deficits do not equally offset each other.
- Functional finance is the third budget philosophy.Advocates argue that the budget is secondary, but the primary purpose of Federal finance is to achieve noninflationary full employment.Government should do what is necessary to achieve this goal regardless of the deficit or surplus in the budget.Proponents offer several responses to critics.

The Public Debt: Facts and Figures

- The public debt in 2000 was $5.7 trillion.This is a large number.One million seconds ago was 12 days back.One trillion seconds ago was around 30,000 B.C.
- Causes of the expansion in debt:
    - National defense and military spending have soared, especially during wartime.During World Wars I and II debt grew rapidly.See Table 18-1 for facts that show World War II debt exceeded GDP.
    - Recessions cause a decline in revenues and growth in government spending on programs for income maintenance.Such periods included 1974-75, 1980-82, 1990-91.
    - Tax cuts are another cause.Tax cuts in the 1980s without equivalent spending cuts led to increasing debt.The Clinton administration in 1993 is an example of how hard it is to reduce spending and raise taxes to reduce the deficit.An unpopular deficit reduction act was passed in that year and many Democrats lost elections later.
- Quantitative aspects of the debt are found in Table 18-1.Note that the absolute level in column 2 is not meaningful without comparison of the relative size of debt and interest payments to the nation's ability to pay, as estimated by GDP and shown in column 5.
    - Comparing the debt to GDP is more meaningful than the absolute level of debt by itself.Use the example of a family or corporate borrowing.For a prosperous family or firm, $100,000 worth of debt may be a small fraction of their income; for others, $100,000 worth of debt may mean they're unable to make payments on the debt.The amount is not as important as the amount relative to the ability to pay.Also, most borrowing is made to purchase physical assets such as buildings, equipment, etc.Another way to judge government debt is to compare it to an estimate of public assets.
    - International comparisons show that other nations have relative public debts as great or greater than that of the U.S. when compared to their GDPs.See Global Perspective 18-1.
    - Interest charges as a percentage of GDP represent the primary burden of the debt today.
    - Who owns the debt is also an important question.About one-fourth of U.S. debt is held by government agencies and the Federal Reserve; the rest is held by individuals, banks, investment and insurance companies, and about 23 percent was held by foreign investors in 2000.See Figure 18-1.

    - Social Security Trust Fund considerations may obscure the true debt picture.Payroll taxes currently exceed social security payments so the fund's surplus is counted as part of the Federal surplus.Some economists say this fund should not be part of the calculation of Federal deficits or surpluses because social security funds are earmarked for future beneficiaries.For example, the Federal surplus in 2000 would be only $87 billion without the fund surplus of $80 billion.
- False concerns about the federal debt include several popular misconceptions:
    - Can the federal government cannot go bankrupt?There are reasons why it cannot.
        - The government does not need to raise taxes to pay back the debt, but it can refinance bonds when they mature by more borrowing, that is, selling new bonds. Corporations use similar methods-they almost always have outstanding debt.
        - The government has the power to tax, which businesses and individuals do not have when they are in debt.
    - Does the debt impose a burden on future generations? In 2000 the per person federal debt in U.S. was $20,667. But the public debt is a public credit-your grandmother may own the bonds on which taxpayers are paying interest. Some day you may inherit those bonds which are assets to those who have them. The true burden is borne by those who pay taxes or loan government money today to finance government spending. If the spending is for productive purposes, it will enhance future earning power and the size of the debt relative to future GDP and population could actually decline. Borrowing allows growth to occur when it is invested in productive capital.

- Substantive issues do exist.
    - Repayment of the debt affects income distribution.If working taxpayers will be paying interest to the mainly wealthier groups who hold the bonds, this probably increases income inequality.
    - Since interest must be paid out of government revenues, a large debt and high interest can increase tax burden and may decrease incentives to work, save, and invest for taxpayers.
    - A higher proportion of the debt is owed to foreigners (about 23 percent) than in the past, and this can increase the burden since payments leave the country.But Americans also own foreign bonds and this offsets the concern.
    - Some economists believe that public borrowing crowds out private investment, but the extent of this effect is not clear (see Figure 18-2).
    - There are some positive aspects of borrowing even with crowding out.
        - If borrowing is for public investment that causes the economy to grow more in the future, the burden on future generations will be less than if the government had not borrowed for this purpose.
        - Public investment makes private investment more attractive. For example, new federal buildings generate private business; good highways help private shipping, etc.

Deficits and Surpluses: 1990-2010

- Figure 18-3 shows huge absolute size of deficits in early 1990s.
- In 1993 Congress passed Deficit Reduction Act to increase tax revenues by $250 billion over 5 years and to reduce spending by a similar amount.
    - Top marginal tax rate went from 31 to 39.6%.
    - Corporate income tax rate went up 1% to 35%.
    - Gasoline excise tax rose by 4.3 cents per gallon.
    - Spending was held at 1993 levels (unless increases already mandated by law).
- By 1998 there was a budget surplus for the first time since 1969.
- There are four main options for the surpluses.
    - Pay off part of the public debt.
    - Less government borrowing could mean more private investment.
    - Critics contend that the debt is shrinking relative to GDP and we need government securities as safe investments, for monetary policy, and for social security trust fund assets.
    - Reduce taxes and reduce surplus.
        - Returns money directly to those who earned it.
        - Helps to limit size of government.
        - Critics fear this surplus may be temporary and tax reduction may be poorly timed if economy is prosperous anyway.
    - Increase government spending and reduce the surplus.
        - Several areas of need exist where federal spending programs could help, especially Medicare drug coverage.
        - Critics say new spending could be inflationary and interfere with private investment.
    - Add to the Social Security trust fund. See Figure 18-4.
        - We could pay off debt and use interest savings for the trust fund.
        - More funds will be needed in future as population ages and fewer workers remain to support larger proportion of retired population.
    - Combine any or all of these four proposals.

Last Word: Debt Reduction and the U.S. Trade Deficit

- Some economists believe the debt and trade deficits are connected.
- Here's why.Higher interest rates may result from government borrowing, which has an international impact because:
    - The dollar will appreciate as foreigners demand more dollars to invest in the U.S. to earn higher interest rates.
    - As the dollar appreciates, American goods become more expensive to foreigners and foreign goods become less costly to Americans.This contributes to the trade deficits more imports and fewer exports.
    - Since net exports are a component of aggregate demand, the net export effect will be negative and slow economic growth.

- If the U.S. pays down the national debt, it will be borrowing less, which should reduce interest rates.Then, the reverse process will occur: the dollar will depreciate and trade deficit will shrink.
- There are other related effects.
    - Foreign investment helps to finance U.S. borrowing so less foreign investment may offset some of the decline in interest rates.
    - Lower U.S. interest rates may reduce the burden on foreign borrowers of U.S. funds as their debt is refinanced at lower rates.This can help developing countries.
    - A trade deficit means we are not exporting enough to pay for the imports.The difference must be paid by borrowing from people and institutions abroad, or by selling U.S. assets to foreigners for the dollars they earned from our import buying.
- However, many factors besides real interest rates affect the trade balance so reducing the debt may not reduce the trade deficit.