

## The Federal Budget and the National Debt

**Full Length Text** — Part: 6 Chapter: 5  
**Macro Only Text** — Part: 5 Chapter: 5

To Accompany “Economics: Private and Public Choice 11th ed.”  
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Slides authored and animated by:  
James Gwartney, David Macpherson, & Charles Skipton

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## Deficits, Surpluses, and the National Debt

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## Deficits, Surpluses, and the National Debt

- **National debt:** the sum of the indebtedness of the federal government in the form of interest-earning bonds. It reflects loans to the U.S. Treasury.
- A **budget deficit** increases the size of the national debt by the amount of the deficit. Conversely, a **budget surplus** allows the federal government to pay off bondholders and so reduce the size of the national debt.
- The **national debt** represents the cumulative effect of all the prior budget deficits and surpluses.

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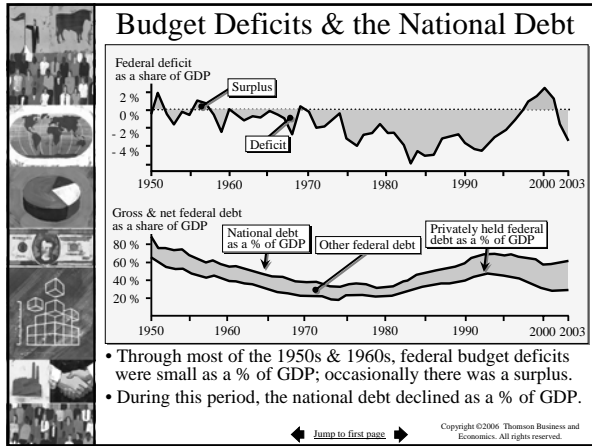
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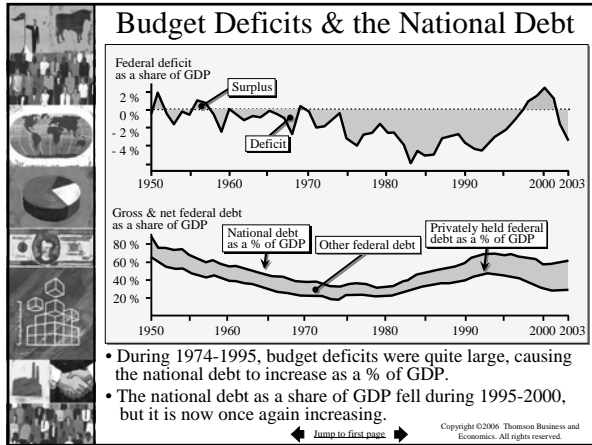
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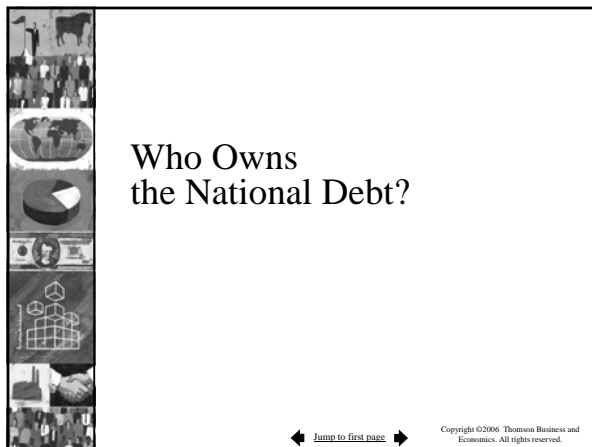
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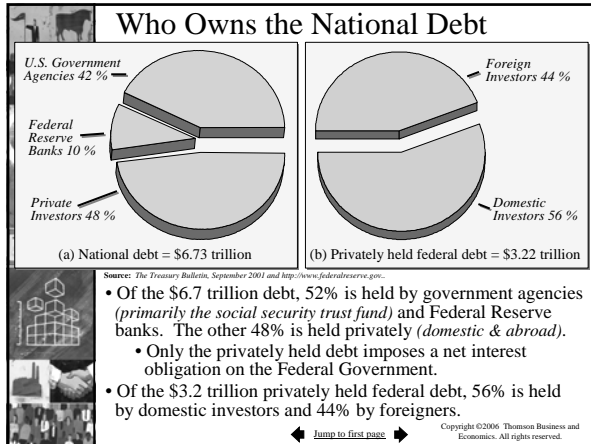
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### How Does Debt Financing Influence Future Generations?

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### How Does Debt Financing Influence Future Generations?

- For domestically held debt (56% of total privately held debt), the future generations that pay the tax liability accompanying the debt will also receive the interest income.
- The *opportunity cost* of resources used by the government is incurred during the current period regardless of how the government activity is financed.

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### How Does Debt Financing Influence Future Generations?

- **Budget deficits** affect future generations through their impact on capital formation. There are *two views about their effects*:
  - The **traditional view** is that budget deficits reduce future capital stock by increasing current consumption, pushing up real interest rates, and retarding private investment.
  - The **new classical theory** argues that people will increase their savings in anticipation of the higher future taxes implied by additional debt, leaving interest rates, consumption, and investment unaffected.

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### How Does Debt Financing Influence Future Generations?

- The **empirical evidence** on the impact of the Federal budget deficit is mixed.
  - Empirical studies have found little, if any, relationship between year-to-year changes in the budget deficit and real interest rates — providing support of the **new classical theory**.
  - Consistent with the **traditional view**, when budget deficits rose sharply during the 1980s, U.S. current consumption expenditures rose while domestically financed capital formation fell, and net foreign investment rose while net exports fell.

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### Influence of Foreign Investment

- The inflow of foreign capital leads to lower interest rates and greater investment than would take place in its absence, increasing the productivity and wages of U.S. workers.
- Wisely invested funds will generate returns (*future income*) that will offset the future income claims of foreigners; but poorly invested funds will not.
- If foreigners suddenly tried to sell their assets here, falling prices would create bargains for domestic investors; domestic investors would gain and foreign investors would lose.

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### Influence of Foreign Investment

- The vulnerability accompanying foreign investment lies mainly with the foreign investor, because the investment is a hostage to the domestic policies of the recipient country.
- A major reason why investment in the United States is attractive to foreigners is their confidence that the U.S. government will follow sound policies and not confiscate investment properties.

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### Government Debt: A Cross-Country Comparison

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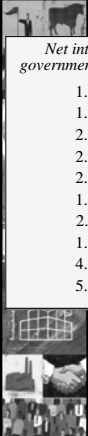
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### Government Debt of Industrial Countries

Net interest on government debt, 2003		Net public debt as a share of GDP, 2003	
1.5 %	Australia	3 %	
1.5 %	United Kingdom	34 %	
2.1 %	Canada	35 %	
2.2 %	Spain	38 %	
2.8 %	France	43 %	
1.8 %	United States	46 %	
2.7 %	Germany	52 %	
1.6 %	Japan	79 %	
4.8 %	Italy	94 %	
5.3 %	Belgium	94 %	

Source: OECD Economic Outlook, June 2004, Annex Tables 31 and 33. Note: Net interest is calculated as a share of GDP.

- A large national debt relative to the size of an economy leads to a large tax burden just to pay the interest on the debt.
- The net public debt as a share of GDP of the United States falls in the middle among the OECD countries.

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## Social Security, Budget Deficits, and the National Debt

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## Social Security, Budget Deficits, and the National Debt

- Social Security revenues and expenditures are generally included in budget deficit calculations.
- Because Social Security is currently running a surplus, inclusion of these figures reduces the size of the reported deficit.

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## Political Economy, Demographics, and Debt Financing

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### Political Attractiveness of Budget Deficits

- Spending makes it possible for politicians to provide voters with benefits now, but when financed by taxes, current costs are also imposed on voters.
- Debt financing (*borrowing*) can push the need for higher taxes into the future.
- Debt financing is attractive to politicians because it makes it possible for them to provide voters with immediate benefits without having to levy current taxes.

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### Future Budget Prospects

- Budget deficits are likely to expand in the decade ahead because:
  - Spending on defense and domestic security is likely to grow as the result of terrorist threats.
  - Spending on Social Security & Medicare will grow rapidly once the baby boomers begin retiring following 2010.
  - Spending is attractive to politicians; taxation is not.

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### Questions for Thought:

1. Does the national debt have to be paid off at some time in the future? What will happen if it is not?
2. What is the difference between the national debt and the privately held federal debt? Is the difference between the two important? Why or why not?
3. Do budget deficits increase the national debt? Do the deficits increase the supply of money (*M1*)? Can the money supply increase when the U.S. Treasury is running a budget surplus?

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**Questions for Thought:**

- "The national debt is a mortgage against the future of our children and grandchildren. We are forcing them to pay for our current consumption of goods and services."  
-- Is this statement *true*?
- How is the social security system currently influencing the size of the budget deficit? How will it influence the budget deficit in the years following 2018? Is this a cause for concern?
- Would Americans be better off if foreigners were prohibited from the purchase of U.S. government bonds? Why or why not?

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**End  
Special Topic 5**

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