WHY DOES THE FEDERAL GOVERNMENT OVERSPEND ITS BUDGET?

INTRODUCTION

History Throughout its history the U.S. government has for the most part balanced its budget, except during times of war and the Great Depression. Since the 1960s, however, the federal government has engaged consistently in deficit spending. Early in the 1990s the deficits reached record levels, and no signs point clearly to a reversal of the trend. These large deficits, incurred in times of relative peace and prosperity, cause many Americans to worry.

by late 90's ran surplus

Mystery Since sustained deficit spending is generally agreed to be harmful, why do the deficits continue?

Economic History The consistent pattern of deficit spending since the 1960s reflects an unspoken consensus among voters and politicians. Individuals object to the deficits, but collectively the nation has accepted them. In accepting them, voters and politicians exemplify economizing behavior. Voters gain benefits from government programs some of which are paid for with borrowed money. Politicians gain the support of voters who benefit from these programs. When deficits drive up interest rates, people who hold savings gain in particular. By comparison with the direct, immediate benefits conferred by deficits, the costs in lower productivity and future output appear remote and indefinite.

CONCEPTS

National Debt
Deficit
Incentives

OBJECTIVES

♦ Define "federal budget deficit" and observe the pattern of increasing deficit levels since 1960.

♦ Recognize the influence of incentives on the choices of voters and politicians.

♦ Predict the level of support for different proposals to reduce federal deficits using their knowledge of the role of incentives.

LESSON DESCRIPTION

The teacher will present a definition of "federal budget deficits" and provide a historical overview of deficits since 1960. Students will use the HDG principles to predict levels of support for different proposals to reduce the deficit.

TIME REQUIRED

♦ One class period

MATERIALS

One transparency each of Visuals 1, 2, and 3.

PROCEDURE

1. Ask students if they know what a billion dollars could buy? Present some examples.

If the school district budget is $100 million, then a billion dollars could fund the school district for 10 years.

If you earned $10 million a year, it would take you 100 years to earn a total of a billion dollars.

If you spent just over $1900 per minute, 24 hours per day, for 365 days, you would spend $1 billion.

One billion dollars is a lot of money! But it is only 7/100 of 1 percent (.07%) of the total money spent by the federal government in 1992.

2. Tell the students that even with all this revenue, the U.S. government *overspent* its budget by $348 billion in 1991.

3. Show students Visual 1. Explain the difference between a budget deficit and the national debt.

A *budget deficit* is the difference between what the government spends in one year and its revenue in that same year when the expenditures are greater than the revenue. (In 1992 the federal budget deficit was estimated to be $400 billion.)

The *national debt* is a total of all the unpaid deficits incurred by the federal government. (In 1992 the national debt was about $4 trillion.)

4. Ask students to make a generalization about the pattern of federal deficits illustrated in Visual 1. (The average deficit is larger in each decade.)

5. Show students Visual 2. Explain that using supply and demand analysis applied to the market for loanable funds helps us anticipate the consequences of the deficits. The U.S. government must borrow money to cover the deficit. It borrows this money from people who save (spend less than they earn). Currently, the U.S. government borrows three–fourths of all the loanable funds available to borrowers in the United States.

Visual 2 illustrates how government borrowing can influence interest rates and private borrowing. Line D_{BD348} is the demand for loanable funds when the government is borrowing $348 billion. D_{BB} is the demand for loanable funds when the government is not borrowing (balanced budget) and only private individuals and firms are borrowing. S is the amount of savings available to borrow at different interest rates.

6. Discuss the following questions:

A. As a result of government borrowing, what happens to the interest rate and the total funds borrowed? (Interest rates are higher [10% vs. 8%]. Total borrowing is greater [900B vs. 800B].)

B. What are the results of large government deficits? (1. The demand for loanable funds increases [shift in the demand curve from D_{BB} to D_{BD348}.] 2. Borrowing by private firms and individuals declines [Point A to Point B 800B to 600B; this is called the "crowding out" effect]. 3. Interest rates are higher than they would be if the government were not borrowing loanable funds.)

C. Who gains and who loses as a result of budget deficits? (Savers who enjoy higher interest rates than would otherwise be the case, and people gain who receive government expenditures which would not exist under a balanced budget. Losers include borrowers who pay higher interest rates and the entire economy if investment declines and economic growth slows. Decreases in investment harm the economy because investment is required to replace old equipment and buildings and to create new and more efficient capital equipment and buildings.)

7. Display Visual 3 and ask the students to bear in mind the following generalization about voters and politicians:

Voters tend to favor political actions that benefit them directly and to oppose actions that directly increase their costs.

Politicians tend to favor political actions that help them satisfy voters and increase their opportunity to win elections.

8. Ask students to judge which proposals will tend to be supported by voters and which proposals will tend to be opposed by voters. (1. Oppose, 2. Oppose, 3. Oppose, 4. Oppose, 5. Oppose, 6. Support, 7. Support, 8. Oppose.)

CLOSURE

Ask students to write a sentence or two, consistent with economic reasoning, which explains why the federal deficit tends to be ignored by voters and politicians. (Balancing the federal budget would require voters to bear increased direct costs [higher taxes, fewer government services] in order to receive very indirect benefits [lower interest rates, lower consumer costs, greater economic growth]. Therefore, voters support a balanced budget as a general goal but tend to oppose specific changes necessary to meet that goal.)

Several political groups advocate a constitutional amendment which would require Congress to balance the federal budget each year. Use economic reasoning to predict how passage of this amendment might change the behavior of politicians in Congress. (The passage of this amendment would probably change the behavior of politicians. The rules would have been changed and, if they were also enforced, deficit spending would no longer be an alternative for members of Congress. They would have to find other ways to convince voters to support their actions.)

Note to the Teacher: Including this activity does not mean that the authors endorse a balanced budget to the constitution. The activity is simply an example to show that as rules and incentives change, changes in behavior are possible.

VISUAL 1

U.S. GOVERNMENT DEFICITS AND DEBT

DEFICIT: **A budget deficit is the difference between what the U.S. government spends in one year and its revenue in that same year when the expenditures are greater than the revenue.**

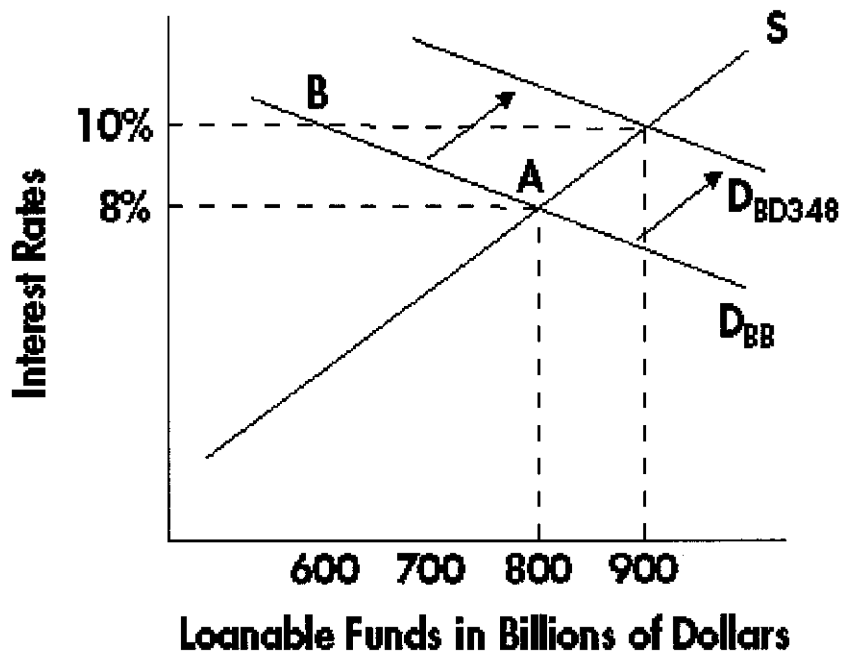
NATIONAL DEBT: **The national debt is a total of all the unpaid deficits incurred by the federal government. (In 1992 the national debt was about $4 trillion.)**

U.S. DEFICIT HISTORY

Decade Average	*Deficit (in billions of dollars)*
1960s	**$6.62**
1970s	**$35.3**
1980s	**$169.0**
1990–91	**$287.5**

VISUAL 2
CONSEQUENCES OF DEFICITS

<u>FEDERAL GOVERNMENT BORROWING</u>: The sources of federal government funds enable it to spend more than it receives in tax revenue.



The consequence of government deficits is the change in demand for loanable funds from D_{BB} (balanced budget, no government borrowing) to D_{BD348} (federal budget deficit of $348 billion); interest rates rise from 8% to 10%, total borrowed funds increase from $800B to $900B, and private borrowing (by individuals and firms) falls from $800B to $600B. (Point B above)

VISUAL 3
PUBLIC CHOICE THEORY

Voters tend to favor political actions which benefit them directly and to oppose actions which directly increase their costs. Politicians tend to favor political actions which help them satisfy voters and increase their opportunity to win elections.

Which of the following proposals would tend to be supported (S) by voters and which would tend to be opposed (O)?

BUDGET DEFICIT REDUCTION PROPOSALS

____1. Reduce federal spending on elementary schools by $10 billion.

____2. Reduce federal spending on highways by $20 billion.

____3. Increase income taxes by $50 billion.

____4. Eliminate income tax deductions to raise $15 billion.

____5. Increase the fees charged to visitors to the national parks, monuments, and forests, to raise $8 billion.

____6. Reduce foreign aid to developing nations by $30 billion.

____7. Reduce purchases of military equipment by $50 billion.

____8. Pass a national sales tax, to raise $150 billion.

LESSON 5
HOW HAS FEDERAL GOVERNMENT SPENDING CHANGED?

INTRODUCTION

The founders of our nation believed strongly in individual freedom and limited government. Between 1789 and 1791 Federal government spending totaled only $4 million, about $1 per capita. (Half of this total went to pay interest on the debt accumulated during the Revolutionary War. By the early 1830s the national debt had been virtually eliminated.) During our nation's first century the belief in limited government continued, and by 1900, Federal government spending amounted to less than 3% of our economy's production of goods and services. During World War II, it ballooned to more than 45%, and although it fell immediately after the war, the low prewar levels of government spending would not be realized again. The expanding economic role of government since World War II has resulted in Federal Government spending now equal to 23% of total output. (When spending by state and local governments is added, the total rises to 35%.)

This growth in the amount of spending has been accompanied by a significant change in the types of programs being funded. Only one-fourth of Federal government spending is now used for the more traditional government purchase programs such as defense, transportation, physical resources, commerce, and international affairs. More than 60% is now for transfer payments such as direct payments to individuals, and grants to state and local governments. When the payment of interest on the national debt is added to this latter amount, nonpurchase related spending equals three-fourths of total Federal government spending.

CONCEPTS

Role of Government
Government Purchases
Government Transfer Payments
Government Interest Payments

OBJECTIVES

◆ Identify some government programs that have grown significantly in recent years, and some which have declined in importance during that time

◆ Differentiate among the three categories of government spending - purchases, transfer payments, and interest payments, and identify examples of each

◆ Examine the changing importance of these three types of spending programs in the budget of the Federal government since 1960, and discuss the significance of these trends

LESSON DESCRIPTION

Students examine a list of selected Federal government expenditures to determine which have grown the most and which have declined the most in importance in recent years. They review the definitions of government purchases and transfer payments and categorize the listed expenditures. Finally, given Federal government budget data, they draw graphs of the relative importance of different types of spending in the budget to discern the pattern of change and its significance.

TIME REQUIRED

One class period

MATERIALS

- ○ One transparency of Activity/Visual 1, "Changes in Selected Categories of Federal Government Spending, 1970–1993"
- ★ One transparency of Activity/Visual 2, (Types of Government Spending: Purchases, Transfers, and Interest)
- ○ One transparency of Activity/Visual 3, "Trends in U.S. Federal Government Spending, Purchases vs Transfers Plus Interest, 1960–1993"
- ★ One copy for each student of Activity 1, "Name that Program: Purchase or Transfer?"
- ★ One copy for each student of Activity 2, "U.S. Federal Government Spending, 1960–1993" and a sheet of Graph Paper

★ all students–basic course material
■ average and above average students
○ average and below average students

PROCEDURE

1. Using Activity/Visual 1, ask the students to determine which categories of Federal government spending have grown the most in importance since 1970, and which have declined the most.

2. Use Activity/Visual 2 to explain the difference between government purchases, government transfer payments, and government interest payments. Divide the class into small groups and distribute a copy of Activity 1 to each group. Have the students categorize each of the programs on the list as either a government purchase or a government transfer payment. (The Sea Wolf Submarine, Meat Inspection, Space Shuttle, Lawn Mowing at Arlington Cemetery, and the National Weather Service are purchases; Unemployment Compensation, Federal Employee Retirement Pensions, and Food Stamps are transfers.)

3. Provide each group with a copy of Activity 2 and a sheet of graph paper. Ask them to prepare a graph showing the portion of Federal spending going for purchases and the portion going for transfer payments and interest between 1960 and 1993. Then, using Activity/Visual 3, discuss the trends in these types of spending. (Purchases have declined as a portion of Federal government spending since 1960, and transfers and interest have increased. The big shift between 1970 and 1975 resulted from a variety of factors: defense cutbacks at the end of the Vietnam War, increased unemployment compensation and welfare spending resulting from the oil crisis-related recession of 1974–1975, and major increases in Social Security benefits, partially the result of inflation-related cost-of-living adjustments and partially the result of the growing number of retired people. The next big shift, between 1990 and 1993 resulted from post-Cold War defense cutbacks, and further increases in spending on Social Security and Medicare.)

CLOSURE

Purchases have declined significantly as a portion of the Federal government budget. Many analysts think that if significant reductions in the Federal government budget deficit and the national debt are to be achieved, taxes must be increased or a reduction in government transfer payments must occur. Discuss the pros and cons of each of these options. Since many transfer payment recipients are legally "entitled" to them, they are difficult to reduce. Also point out that lower interest rates would automatically reduce government spending and that economic growth would automatically increase tax revenues. Policies designed to achieve these latter goals will be discussed in subsequent lessons.

ACTIVITY/VISUAL 1
CHANGES IN SELECTED CATEGORIES OF FEDERAL GOVERNMENT SPENDING, 1970–1993

(Percent of Federal Government Expenditures)

Category	1970	1993
National Defense	41.8%	20.7%
Education & Training	4.4	3.6
Income Security	3.2	14.7
Medicare	3.2	10.2
Social Security	15.5	21.6
Veterans Benefits	4.4	2.5
Energy & Environment	2.1	1.7
Transportation	3.6	2.5
Interest on Debt	7.4	14.1
All Other Categories	14.4	8.4

Source: *The Budget for Fiscal Year 1995–Historical Tables,* Washington, D.C.: U.S. Government Printing Office, 1994.

ACTIVITY/VISUAL 2
TYPES OF GOVERNMENT SPENDING PURCHASES, TRANSFERS, AND INTEREST

GOVERNMENT PURCHASES are sums of money that are used to pay for the goods and services bought by all levels of government. Payment for army tanks, asphalt for highways, and public school teacher salaries are examples of government purchases

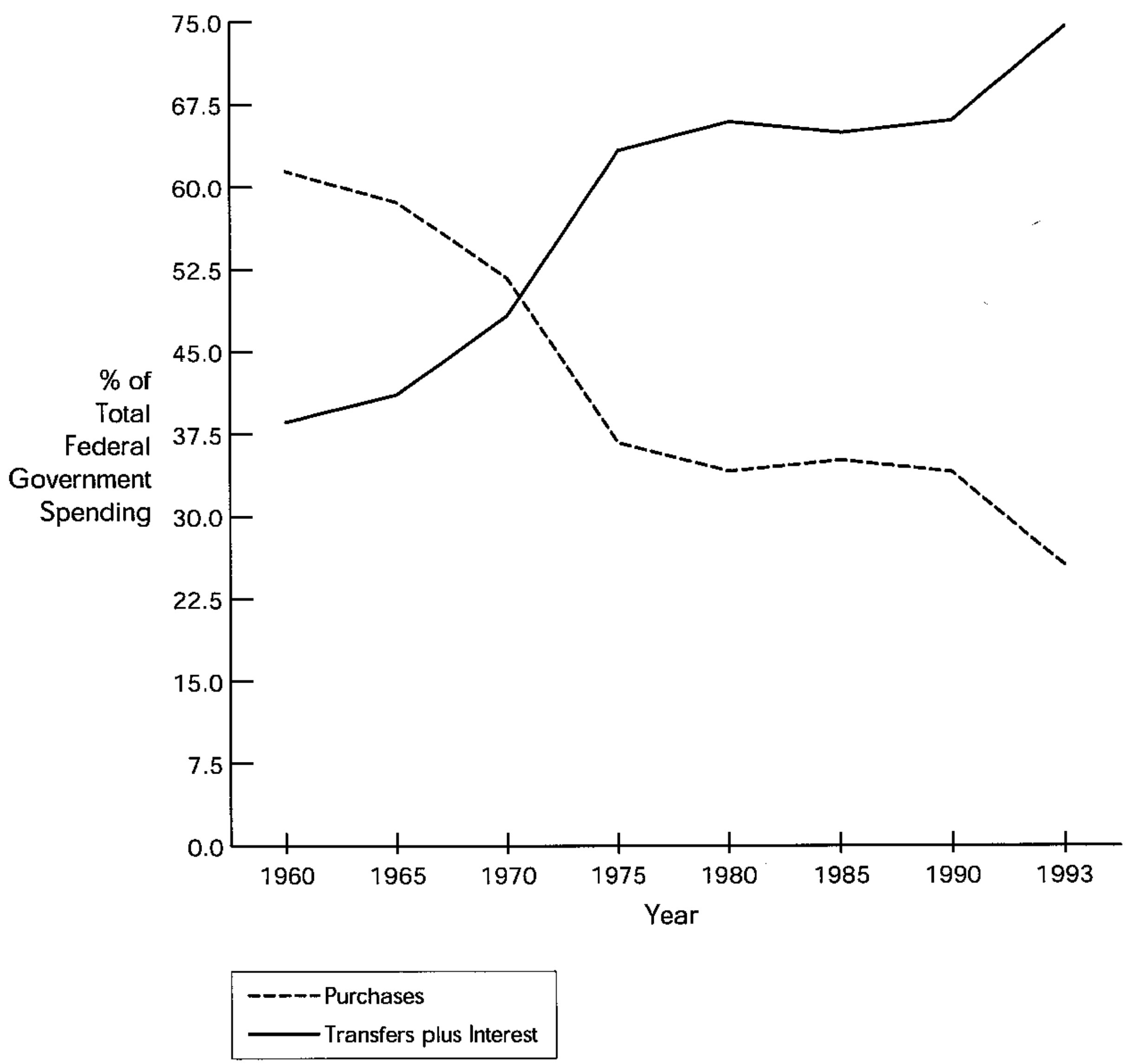
GOVERNMENT TRANSFER PAYMENTS are sums of money that certain individuals receive as outright grants from the government rather than as payments for goods provided or services rendered. Social Security and welfare payments are examples of government transfer payments. Many transfer payments are considered to be "entitlements," which are programs requiring payments to all those who meet the eligibility requirements.

GOVERNMENT INTEREST PAYMENTS are sums of money paid as interest on the national debt, which has accumulated as the result of past and current budget deficits.

ACTIVITY/VISUAL 3

TRENDS IN U.S. FEDERAL GOVERNMENT SPENDING PURCHASES VS. TRANSFERS PLUS INTEREST

1960–1993



Source: *The Budget for Fiscal Year 1995–Historical Tables,* Washington, D.C.: U.S. Government Printing Office, 1994.

ACTIVITY 1
NAME THAT PROGRAM: PURCHASE OR TRANSFER?

Name ______________________

Federal Spending Program	**Type (Purchase or Transfer)**
Sea Wolf Submarine	______________
Unemployment Compensation	______________
Meat Inspection	______________
Federal Employee Retirement Pensions	______________
Food Stamps	______________
Space Shuttle	______________
Lawn Mowing at Arlington Cemetery	______________
National Weather Service	______________

ACTIVITY 2
TYPES OF U.S. FEDERAL GOVERNMENT SPENDING, 1960–1993

Name ________________________

(Percent of Total Federal Spending)

TYPE OF SPENDING	1960	1965	1970	1975	1980	1985	1990	1993
National Defense	52.2	42.8	41.8	26.0	22.7	26.7	23.9	20.7
Other Purchases	9.2	15.8	9.9	10.7	11.4	8.4	10.1	4.8
TOTAL PURCHASES	61.4	58.6	51.7	36.7	34.1	35.1	34.0	25.5
Direct Payments to Individuals	23.5	24.9	28.7	41.2	41.6	39.9	40.5	46.7
Grants to State and Local Governments	2.7	3.1	4.5	5.0	5.5	5.5	6.2	8.8
Other Grants	4.9	5.9	7.7	10.1	9.9	5.8	4.6	4.9
TOTAL TRANSFERS	31.1	33.9	40.9	56.3	57.0	51.2	51.3	60.4
Interest on Debt	7.5	7.5	7.4	7.0	8.9	13.7	14.7	14.1
TOTAL TRANSFERS PLUS INTEREST	38.6	41.4	48.3	63.3	65.9	64.9	66.0	74.5

Source: *The Budget for Fiscal Year 1995–Historical Tables,* Washington, D.C.: U.S. Government Printing Office, 1994.

Unit 6 Lesson 36

Should We Worry About the National Debt?

Introduction

Economics The U.S. national (or public) debt is one of the most discussed and least understood issues in macroeconomics. People frequently fail to distinguish the national debt from an annual budget deficit, and, when there is a budget surplus, they think there is no longer a national debt. The national debt represents the sum of the annual budget deficits, minus annual surpluses, incurred since the Revolutionary War. Whether or not it should be paid off and how it affects the economy are topics that are both interesting and controversial among economists.

Reasoning The **Guide to Economic Reasoning** tells us that the consequences of actions lie in the future. This point seems to raise questions about the national debt: does today's deficit, or failure to pay off the debt today, impose costs on future generations? With respect to the debt held by foreigners, the answer is probably yes. Economic reasoning also tells us that it is important to weigh the costs and benefits of actions in making decisions. In analyzing the costs and benefits of incurring a budget deficit or what to do with a surplus, government decision makers are employing the economic way of thinking.

Concepts

- Bonds
- Budget deficit
- Budget surplus
- National (public) debt

Objectives

Students will:

1. Explain the difference between the national debt and an annual deficit.
2. Identify and explain causes of the national debt, and how it is financed.
3. Analyze issues concerning the problem of the national debt.

Content Standards

- Costs of government policies sometimes exceed benefits. This may occur because of incentives facing voters, government officials, and government employees, because of actions by special interest groups that can impose costs on the general public, or because social goals other than economic efficiency are being pursued. (NCEE Content Standard 17)
- Federal government budgetary policy and the Federal Reserve System's monetary policy influence the overall levels of employment, output, and prices. (NCEE Content Standard 20)

Lesson Description

Students discuss the size of the current national debt and what this means. A class discussion covers the causes of the debt, how it is financed, definitions of a budget deficit and budget surplus, and the difference between a budget deficit and a trade deficit. Students then participate in an activity presenting different perspectives on whether the national debt is a problem of major concern.

Time Required: 60 minutes

Materials

- A transparency of Visual 1
- Handouts 1 and 2 (see pp. 236, 237)

Procedure

1. Explain that this lesson will focus on the national debt and issues related to it. The level of the national debt is often expressed in trillions. Ask the students to describe how big a trillion is.

   (Answers will vary. A trillion is a one followed by 12 zeros, or a thousand billion. In terms of time, it takes over 30 years for a billion seconds to pass, so it takes over 30,000 years for a trillion seconds to pass.)

2. Tell the students that the national debt, also called the public debt, was almost $6 trillion in February 2002. (Note: You can easily find out the current size of the national debt to the penny, and other information about the national debt, by going to www.publicdebt.treas.gov.)

3. Display Visual 1. Discuss the answers to the questions.

   A. What is the national debt?

   (The government gets revenues from taxes, and it spends on goods and services. If spending in any one year is equal to revenues, the government's budget is balanced. If spending is greater than revenues in any one year, there is an annual budget deficit. If revenues are greater than spending in any one year, there is an annual budget surplus. The national debt, also called the public debt, is the total owed by the

federal government to those from whom it has borrowed. The national debt is the total of all the annual deficits accumulated since 1776, minus all the annual surpluses.)

B. What caused the national debt?

(Most of the U.S. national debt can be attributed to three things: paying for wars, increased government spending during recessions, and tax decreases not accompanied by decreases in government spending.)

C. Where does the government get the money when it wants to spend more than it takes in?

(The government borrows money. It does this by selling government securities, such as bonds. A bond is essentially an I.O.U. — that is, those who buy government bonds are loaning money to the government. When bonds come due, bondholders are paid back the money that they paid for the bond initially. Meanwhile, bondholders are paid interest on their bonds. The government also has the power to print money, and some governments finance their deficits in this way. The U.S. government generally does not do this.)

D. What is a budget deficit?

(A budget deficit occurs in any year in which federal government spending is greater than federal revenues, and is measured as the difference between the two. For example, in 1993 there was an annual deficit of about $255 billion.)

E. What is a budget surplus?

(A budget surplus occurs in any year in which federal government revenues are greater than federal spending, and is measured as the difference between the two. For example, in 2000 there was an annual surplus of about $236 billion. It is important to realize that just because there is a surplus in any given year, this does not mean that there is no national debt.)

F. Is a budget deficit the same as a trade deficit?

(No. A budget deficit is the difference between government revenues and spending in any year for which spending is greater than revenues. A trade deficit occurs when the value of goods and services imported is greater than the value of goods and services exported in a country.)

4. Tell the students that they will now read a one-page handout addressing the issue of whether or not the national debt is a big problem. Divide your class in half. Give each student in half the class a copy of Handout 1; give each student in the other half a copy of Handout 2. (Handout 1 presents the view that the national debt is not a big problem; Handout 2 presents the opposite view.) Provide time for the students to read the handouts.

5. Discuss the handouts. Do not reveal to the students that there were two different versions of the handout until they figure this out from the discussion. The discussion should bring out some of the very real controversies about the national debt. The information presented on both Activities is true, and it represents opinions held by some economists.

   Suggested discussion questions, and possible answers:

   - Will the national debt cause the United States to go bankrupt?

     (Handout 1: Not as long as people are willing to purchase U.S. bonds, so the debt can be refinanced.)

   - Are the interest payments on the debt important?

     (Handout 2: Yes. They represent 14 percent of total government spending. This money could be used for other things.)

   - What about paying off the national debt by increasing taxes?

     (Handout 1: This could be done.)

     (Handout 2: If taxes are increased, the increase affects people's incentives to work and invest. This could hurt economic growth.)

   - Does running deficits today, and adding to the national debt, put a burden on future generations?

     (Handout 1: This isn't a big problem because people in the future also inherit the bonds, and today's spending may benefit future generations.)

     (Handout 2: The portion of the debt held by foreigners, about 22 percent, is a problem for future generations because the money paid back to bondholders will go out of the country.)

   - Is "crowding out" a problem resulting from the national debt?

     (Handout 1: Not necessarily, provided the government uses the money borrowed for investment, and provided that government investment is viewed as being as good as private investment.)

     (Handout 2: Among other things, crowding out results in the government growing larger and the private sector growing smaller. Most Americans don't want big government.)

   - Would a law or a Constitutional amendment requiring a balanced budget be a good idea?

(Handout 1: No, because it would limit the government's ability to conduct discretionary fiscal policy, and that could make problems of recession and inflation worse.)

(Handout 2: This could be a good idea, because the government doesn't appear to be able to control its spending in other ways.)

- How does the U.S. national debt compare to that of other countries?

  (Handout 1: In terms of percentage of GDP, it is lower than that of many industrialized nations.)

  (Handout 2: The U.S. national debt is the largest in the world.)

- Does the national debt hurt poor people more than wealthier people?

  (Handout 2: The people who buy the bonds tend to be wealthier, while all taxpayers pay interest, including poorer Americans. Therefore, wealthier people may benefit at the expense of the poor.)

Closure

Assign the students who read Handout 1 to read Handout 2; assign those who read Handout 2 to read Handout 1. For homework, assign the students to write a one-page essay assessing both sides of the question, "Should We Worry about the National Debt?"

Multiple-Choice Questions

(Correct answers shown in bold)

1. The U.S. national debt:
   - A. Is zero. The United States is not in debt to anyone.
   - **B. Is owed to people who have bought U.S. government bonds.**
   - C. Is owed mostly to people in foreign countries who export goods to the United States.
   - D. Is less than $1 trillion.
2. A government budget deficit occurs when:
   - **A. The government spends more than it collects in revenues.**
   - B. The government collects more in revenues than it spends.
   - C. The Federal Reserve lends more than it borrows.
   - D. The Federal Reserve borrows more than it lends.

Essay Question

Some people believe we should worry about the national debt; others believe that it is not a big problem. Select one side of this argument and defend your opinion.

(Answers will vary. Those who say the debt is a problem can argue that the interest payments on the debt are significant; that the portion of the debt held by foreigners imposes a burden on future generations; that "crowding out" may occur; and that the U.S. national debt is the largest in the world. Those who say it is not a problem can argue that as long as people are willing to buy U.S. bonds, the debt can be rolled over; that the debt is not that large as a percentage of GDP; that the debt doesn't really burden future generations; and that crowding out is not a big problem.)

Unit 6, Lesson 36

Handout 1

Should We Worry about the National Debt?

In early 2002, the U.S. national debt was almost $6 trillion. This amounts to over $20,000 for every man, woman, and child in the United States. Is this a problem for our economy? Many economists argue that this is not as big a problem as it may appear. Let's look at the reasons for this point of view.

When individuals are seriously in debt, they may be in danger of going bankrupt because they can't get enough money to pay their bills. This is not true for the U.S. government. For one thing, the government can continue to refinance or "roll over" the national debt. When one person's bonds become due, it can sell bonds to someone else to pay off the first person. U.S. government bonds are a very safe investment paying competitive interest rates, so there is no shortage of people here and abroad willing to buy them. As long as people are willing to buy U.S. government bonds, the government will be able to refinance the debt. Also, the government has the ability to tax. If people wanted to pay off the debt with tax revenues, the government could do this.

Sometimes people say that if the government runs a deficit today, it will put a burden on future generations. They argue that your children and grandchildren will have to pay off today's debt and therefore won't be as well off. But this ignores the fact that people in the future will inherit bonds (an asset) as well as the debt (a liability). And spending today may benefit people in the future. Much of our debt today was used to pay for wars fought by our fathers and grandfathers. Do we feel burdened by this today?

"Crowding out" is frequently cited as a problem of the national debt. When the government borrows money for deficit spending, there is less money for private businesses to borrow, and interest rates increase. This "crowds out" private investment spending and could lead to lower economic growth in the future. But this argument ignores the fact that the government may be using the money it borrows today for investment — in capital goods or in human capital. It may use the money to build roads or bridges, to fund education, or for health care. Certainly these projects would help people today and in the future.

It is important to recognize the problems that would occur if laws were passed requiring the government to balance its budget annually. During times of recession, government tax revenues fall because incomes go down. If it were required to balance the budget, the government would have to reduce its spending to match the lower tax revenues, which would make the recession worse. The opposite is true in periods of inflation: tax revenues go up because people's incomes go up. If it were required to balance the budget, the government would have to increase its spending to equal the higher tax revenues, which would lead to more inflation. The important thing for the government to worry about is controlling unemployment and inflation. A law or Constitutional amendment requiring a balanced budget could take away this power.

It's certainly true that $6 trillion is a large number and a lot of dollars. But it is important to look at this as a percentage of GDP. U.S. GDP was about $10 trillion in 2001, making the national debt about 60 percent of GDP. This is a lower percentage than in many other industrialized countries including Japan, Canada, Italy, Spain, France, and Germany. Another thing to keep in mind is that much of the debt — about 78 percent of it — is owed to U.S. citizens, U.S. businesses and banks, and agencies of the U.S. government. It is Americans owing money to Americans. Viewed this way, paying it off wouldn't really accomplish much: American taxpayers would pay money to American bondholders, but overall national income would remain the same.

Unit 6, Lesson 36

Handout 2

Should We Worry about the National Debt?

In early 2002, the U.S. national debt was almost $6 trillion. This amounts to over $20,000 for every man, woman, and child in the United States. Is this a problem for our economy? Many economists argue that it is a significant problem for both current and future generations of Americans. Let's look at the reasons for this point of view.

The United States has the world's largest national debt, although it is not the largest in terms of percent of GDP. People who hold U.S. government bonds must be paid interest on these bonds. Because the debt is so high, the amount paid in interest is also high: in 2000, interest payments on the debt represented 14 percent of total federal government spending. If interest rates go up in the future, there is a danger of larger and larger portions of government spending going merely to pay this interest. Money spent for interest payments means that less money can be spent on other items like education and health care.

Some people argue that we may never have to pay off the national debt because it can be "rolled over." That is, when some bonds come due, the government can sell more bonds to other people to pay off the first group. Furthermore, the argument goes, the interest paid on the bonds is just a transfer from one group of Americans (the taxpayers) to another (the bondholders), so overall income doesn't really change. But this ignores the issue of the distribution of income. It is generally the more wealthy Americans who are the bondholders — to whom the government debt is owed. But poorer Americans pay taxes too. Therefore the national debt may cause money to be paid to bondholders (richer people) by all taxpayers (including poorer people). Many would argue that this redistribution of income is not fair.

It is true that much of the national debt is owed to U.S. citizens and U.S. government agencies. But a major concern is that 22 percent of the debt is owed to foreigners — up from about 14 percent in 1990. When the bonds owed to foreigners become due in the future, our children and grandchildren will have to pay off these bonds out of their current income. This money will go to foreign countries, not to spending programs in the United States. This foreign held or "external" debt therefore places a burden on future generations of Americans. Our children and grandchildren will have to pay off the debts from our spending today. This is not fair to them.

Some people say we shouldn't worry about the debt because we could pay it off by increasing taxes. A problem with this argument is that raising taxes affects people's incentives to work, to invest, and to innovate. If tax rates go up to pay off the debt or to pay more interest on the debt, people may decide to work less rather than seeing more of their incomes go to taxes. This may hurt economic efficiency, future investment, and the prospects for economic growth in the economy.

"Crowding out" is frequently cited as a problem of the national debt, and it also relates to economic growth. When the government borrows money for deficit spending, there is less money for the private businesses to borrow, and interest rates increase. This "crowds out" private investment spending and could lead to lower economic growth in the future. Additionally, crowding out means that the government ends up controlling a larger share of the economy, and private businesses a smaller share. Most Americans are not in favor of bigger government, and would rather have more control in the hands of private businesses.

If we look at patterns of government spending in the last decades of the 20th century, we see evidence (up to 1998) of growing deficits and a lack of ability on the part of government officials to control their spending. If government bureaucrats can't control their spending, then the people are in a position to do something about it. A law or a Constitutional amendment could be passed to force the government to balance its budget annually.

Unit 6, Lesson 36
Visual 1

QUESTIONS ABOUT THE NATIONAL DEBT

A. What is the national debt?

B. What caused the national debt?

C. Where does the government get the money when it wants to spend more than it takes in?

D. What is a budget deficit?

E. What is a budget surplus?

F. Is a budget deficit the same as a trade deficit?