

The Takeaway

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Trade, Economics, and Public Policy

Two More Reasons Why the Federal Debt Matters

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The national debt is again in the news, having passed 21 trillion dollars and 100% of gross domestic product. Rather than growth generating additional tax revenues that would pay for the tax cuts of 2017, the US budget deficit rose 17% over fiscal year 2017.¹ Nonpartisan economists had predicted the surge would follow the 2017 tax cuts. The goal of this brief is to help readers understand the US federal debt and why it matters.

In 2017, the US federal government took in 3.3 trillion dollars in revenues, but total outlays, or spending, reached nearly 4 trillion dollars. Figure 1 shows how revenues and spending have changed over time.

Prior to 1980, spending and revenues were close but spending started to increase above revenues in the 1980s. Revenues started to increase with the term of George H.W. Bush and eventually overtook spending in the late



WHAT'S THE TAKEAWAY?

To the *many* reasons why the rising US federal debt matters, add:

- 1) The Debt threatens national security.
- 2) The Debt is associated with a higher trade deficit.

It seems a crisis is required before the US federal debt will be addressed with the necessary unpopular sacrifices: higher taxes or lower spending.

1990s. In the 2000s, revenue fell with tax cuts but rose again with economic growth in the 2000s. The 2008 recession caused a drop in tax revenue as personal income fell, and spending increased as the government tried to boost the economy out of the crisis. Revenues have grown with the economic recovery after the crisis, and spending growth has moderated over the last decade. In 2016-2017, spending increased and tax revenue has fell, resulting in rising budget deficits.

There are many academic and popular articles in print and on-line about the why the debt matters. The Congressional Budget Office, for example, points out that the debt:

- reduces our ability to respond to economic shocks,
- increases interest payments (thus reducing money that could be used for tax cuts or spending programs, depending on your preference),
- increases the chance of a fiscal crisis,
- increases the chance of lower national savings,
- and increases the chance of lower income in the long run.²

There are at least two more reasons why we should care about the debt.

THE DEBT THREATENS NATIONAL SECURITY

Back in 2011, former Joint Chiefs of Staff Chair Michael Mullen warned that “the single, biggest threat to our national security is debt.”³ In early 2018, National Intelligence Director Daniel Coats called the debt “a dire threat to our economic and national security.”⁴ According to the Congressional Budget

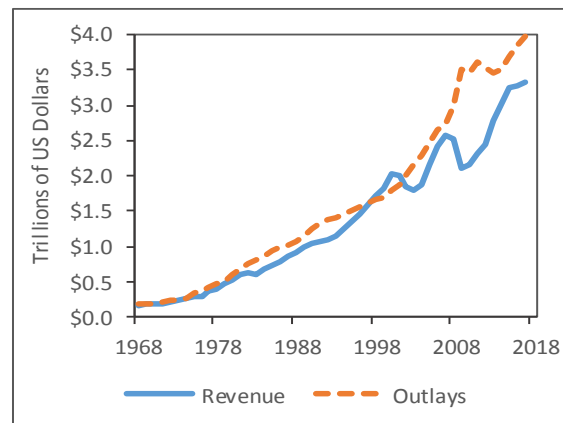
Office,⁵ China held 18% of US debt in September 2018. Japan is the next largest holder of US debt at 16%. No other country holds more than 6%. At a minimum, as global tensions rise over trade wars, shipping lanes in the South China Sea, and North Korea, holding US debt gives China additional leverage. Refusal on our part to repay the debt could provoke a more serious confrontation. Holding so much US debt also raises the possibility of affecting US interest rates, either through bond sales or exchange rates.

*As global tensions rise...
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THE DEBT IS ASSOCIATED WITH A HIGHER TRADE DEFICIT

Introductory economics textbooks explain the link between the US government debt and the US trade deficit. When a government spends more than it collects, the government

Figure 1: US Federal Government Outlays and Revenue in Trillions of Nominal US Dollars

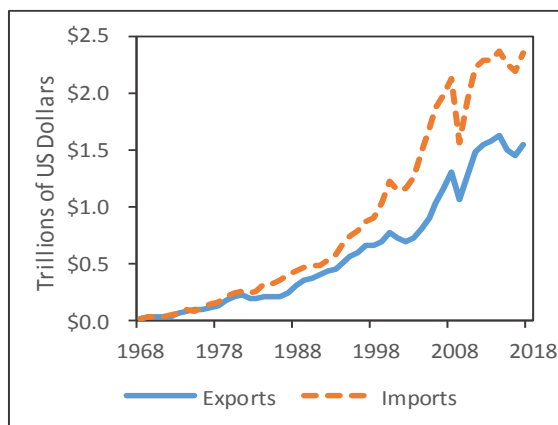


Source: Congressional Budget Office's April 2018 report *The Budget and Economic Outlook: 2018 to 2028*

must make up the difference in one of three ways. The first is to increase taxes or cut spending. If that were possible, however, the gap would not exist in the first place. The second is to print money. Dozens of governments through history have tried this, and we now know that printing money to get out of debt generates inflation. Hyperinflation can devastate the economy, as Venezuela is currently demonstrating. The third option is to borrow money from domestic and foreign lenders. As borrowing increases, the demand for the domestic currency increases over what it would have been otherwise. The result is a rising exchange rate. When the value of the US dollar increases, imports are cheaper and exports are more expensive—leading to a trade deficit.

The last forty years have seen a tremendous growth in US trade. As Figure 2 shows, imports have been rising faster than exports. Note that imports and exports begin to noticeably diverge during the early 1980s, which is the same time at which the US federal debt starts to grow. Imports and exports

Figure 2: US Foreign Trade in Trillions of Nominal US Dollars



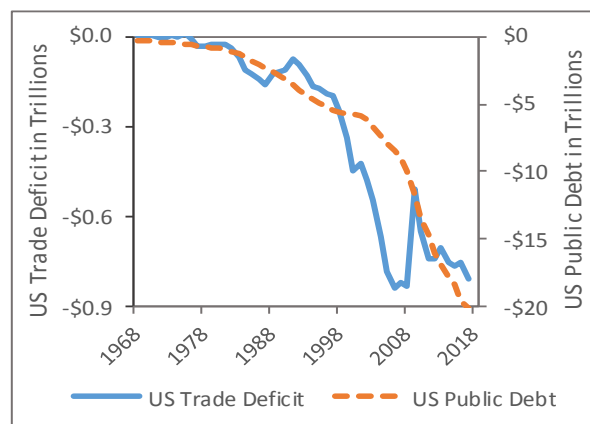
Source: Imports and Exports measured on BOP Basis, US Census Bureau, Economic Indicator Division

follow a similar path, but imports grow at a faster rate. Note that the great trade collapse of 2008 is clearly evident, but imports and exports recover together.

Figure 3 shows the relationship between the US federal debt and US trade deficits. The relationship between the two is strongest in the long-run trend. There are some differences—especially during the US financial crisis in which US demand for imports dropped dramatically—but overall the relationship is very close to that predicted by introductory economics textbooks. If we really care about trade deficits—whether with China or other countries—then we should be concerned about how the US debt may be making those deficits worse.

The relationship between US federal borrowing and the US trade deficit implies that tariffs would only reduce trade deficits in the short run. Tariffs can temporarily increase the trade balance by reducing imports, but since the trade balance is ultimately driven

Figure 3: US Trade Deficit and Government Debt in Trillions of Nominal US Dollars



Source: Total Public Debt: Federal Reserve Economic Data, <https://fred.stlouisfed.org>, Trade Deficit: Balance of Payments from US Census Bureau measured as BOP Basis, Economic Indicator Division

by the difference between US international borrowing and lending, the exchange rate would eventually rise, causing the trade balance to fall again and thus cancel out the effect of the tariffs. The long-run solution to persistent trade deficits, therefore, is to address US borrowing, such as the US federal debt.

Figures 1 and 3 both show that the debt has been rising for the last forty years. Public officials and economists have been warning us about the effects of the debt for at least that long. The debt, however, continues to grow. One possible reason is that addressing the debt will involve significant sacrifice—either in terms of higher taxes or lower spending. Neither option is politically popular; it is very difficult to get elected on a campaign that promotes either policy. The debt, therefore, may not be addressed until we reach a crisis point. Unfortunately, however, predicting when such a crisis might occur is very difficult. Acting now, before the crisis occurs, is the best way to address the problem of the

debt. Acting now will take tremendous courage from our elected officials and give us the best chance to reduce the debt before a disaster forces our response.

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Notes:

¹ Tankersley, J. & Phillips, P. (2018, Nov 12). Trump's tax cut was supposed to change corporate behavior. Here's what happened. *New York Times*. <https://www.nytimes.com/2018/11/12/business/economy/trumps-tax-cut-was-supposed-to-change-corporate-behavior-heres-what-happened.html>

² Congressional Budget Office (2018). <https://www.cbo.gov/publication/54667>

³ Biggs, A. (2018, Sep 22). *The Washington Times*. <https://www.washingtontimes.com/news/2018/may/8/the-single-biggest-threat-to-national-security-is-/>

⁴ Cox, J. (2018, Feb 13). US security chief calls national debt 'a dire threat.' *CNBC*. <https://www.cnn.com/2018/02/13/us-security-chief-calls-national-debt-a-dire-threat.html>

⁵ Congressional Budget Office (2018). <http://ticdata.treasury.gov/Publish/mfh.txt>

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