Debt and Deficits: How Big is Too Big?

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INTRODUCTION

“We will continue along the path toward a balanced budget in a balanced economy.”
- President Lyndon Johnson, January 4, 1965

“We must balance our federal budget so that American families will have a better chance to balance their family budgets.”
- President Richard Nixon, January 22, 1970

“We can achieve a balanced budget by 1979 if we have the courage and the wisdom to continue to reduce the growth of Federal spending.”
- President Gerald Ford, January 15, 1975

With careful planning, efficient management, and proper restraint on spending, we can move rapidly toward a balanced budget, and we will.”
- President Jimmy Carter, January 29, 1978

“[This budget plan] will ensure a steady decline in deficits, aiming toward a balanced budget by the end of the decade.”
- President Ronald Reagan, January 25, 1983

“[This budget plan] brings the deficit down further and balances the budget by 1993.”
- President George H. W. Bush, January 31, 1990

“[This budget plan] puts in place one of the biggest deficit reductions...in the history of this country.”
- President William Clinton, February 17, 1993

“Unrestrained government spending is a dangerous road to deficits, so we must take a different path.”
- President George W. Bush, February 27, 2001

“We need to take responsibility for our deficit, and reform our government.”
- President Barak Obama, January 25, 2011

The above quotes, all taken from Presidential State of the Union addresses, show that deficit reduction has been a common goal of presidents regardless of their differences in political party or economic policies. While the goal may be common, the reality is that government deficits have been trending upward over most of this timeframe and are currently at record levels. This paper aims to explore the trends in deficits and debt, if and when the federal government should engage in deficit spending, and the potential impacts of debts and deficits on the economy as a whole.
RATIONALES FOR DEFICIT SPENDING

Are there good reasons for the government to engage in deficit spending, or is this simply irresponsible behavior? While this is a fairly complicated question, we can gain some insights by examining when household borrowing is considered to be appropriate.

Using Deficits to Smooth Business Cycles

From a personal finance perspective, households should plan their budget so that they are able to pay routine expenses out of their current income. One of the goals of financial planning is to smooth consumption over fluctuations in income that might occur due to changes in employment and retirement. Households are thus expected to save part of their income during their working years to provide for retirement, and to save during years with above-average income to offset years with below-average income.

Because the government does not face the same lifetime constraints, the government does not need to save for retirement purposes. However, business cycle fluctuations naturally affect the government’s balance sheet. During economic downturns, reductions in national income result in reduced tax revenue to the government. In addition, more households qualify for unemployment insurance payments and public assistance programs causing government spending to naturally increase. If the government had expected a balanced budget, they would now be facing a deficit due to reduced tax revenue and increased spending. During periods of rapid growth, the opposite effect occurs, leading to increased tax revenues and reduced government spending. If the government had planned a balanced budget, this would naturally result in a government surplus.

As a result, the government should respond to these fluctuations much like households who smooth their budgets over the long term. This implies that if the government truly desires a balanced budget over the long term, they should plan for a balanced budget assuming that the economy will grow at the average of 2-3% each year. This is typically referred to as a structurally balanced budget. During years when the economy grows faster than average, the government will experience a cyclical surplus; during years where the economy grows slower than average, or even declines, the government will experience a cyclical deficit.

If the government plans for a structurally balanced budget, the impact of business-cycle fluctuations can be smoothed over the long run by saving surpluses during upturns to offset the need for deficit spending during downturns.

Using Deficits to Finance Infrastructure Projects

Turning again to personal finance, it is generally accepted that while households should not normally borrow to cover routine expenses; borrowing is appropriate to finance purchases that provide long-term value to the household. In this case, borrowing allows the household to

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1 Cyclical surpluses/deficits are defined as the part of the actual surplus/deficit attributed to business-cycle fluctuations, rather than planned government revenues and spending.
spread the cost of the purchase over the years when benefits are reaped. Examples would include mortgages for owner-occupied housing and loans to finance education and vehicle purchases.

The same argument can be made for government budgeting. Borrowing is warranted to fund capital investments such as government buildings, new roadways, and other types of infrastructure projects.

**Using Deficits to Steer the Macroeconomy**

A third argument for deficit spending is to help stimulate the economy to reduce the duration and severity of recessions. Because this is looking at a collective, rather than individual, outcome, there is no clear analogy that relates to personal finance. In response to recession, the government can encourage growth in spending, either directly through increased government purchases, or indirectly through tax cuts which allows for greater spending by taxpayers. Either of these options will cause an increase in deficits in order to boost spending in the economy. These increases in spending result in higher incomes which cause total spending to grow further. The end result is that the total growth in the economy exceeds the initial boost provided by deficit spending.

As discussed earlier, recessions will naturally lead to reduced tax revenues and increased spending because of the structure of the tax code, unemployment insurance and public assistance programs. These responses do not require any new action by Congress and are thus often referred to as ‘automatic stabilizers.’ During a deep recession, though, the government may want to further stimulate the economy beyond the impact of automatic stabilizers. This was the argument behind stimulus spending packages introduced under both the Bush and Obama administrations. While the purpose of the stimulus packages was motivated by steering the economy back on course, the use of stimulus funds was fairly consistent with the previous topics discussed; much of it was geared toward infrastructure building, extending unemployment insurance benefits, and alleviating state burdens associated with extended high case-loads in public assistance programs.

The big question is whether such stimulus spending actually works? Unfortunately, there is no clear answer to this question. Opponents of stimulus spending point to the slow, stagnant recovery and claim that these actions have not, in fact, worked to adequately stimulate the economy. Proponents reply that the recession would be deeper and longer without stimulus spending. Economists are fairly divided between these two arguments with no clear consensus on which view is correct.

**NEGATIVE IMPACTS OF DEFICITS AND DEBT**

As stated previously, governments don’t face a specific lifetime constraint for debt repayment; stable governments then have a seemingly infinite time horizon for paying back debt, making it easier to justify government borrowing. However, increased government borrowing is not without consequences and there are potential costs that should be considered.
Reductions in Private Borrowing

One of the main consequences of government borrowing is that it reduces the level of private borrowing to finance business expansions of buildings and equipment. As the government increases their borrowing, the increased competition for loanable funds drives up interest rates making private borrowing more costly. As a result of reduced loanable funds and higher interest rates, less private business borrowing takes place. This causes a reduction in the capital stock which ultimately limits future growth potential.

International Leakages

In a global economy, the impact of government borrowing on the availability of loanable funds and interest rates may be very small due to the availability of loanable funds from other countries. While this avoids the previous problem of reduced capital stock and limited growth potential, it creates new problems in the economy. If either government or private borrowing are financed through foreign sources, then payments on that debt flows outside of the country, rather than recirculating through the economy as increased income and spending. This, too, will limit the growth potential of the U.S. economy into the future. As of January 2011, approximately 47% of the U.S. debt held by the public was foreign-owned, meaning about half of the interest payments are currently flowing to foreign sources (Department of the Treasury, 2011; Congressional Budget Office, 2011).

EMPIRICAL TRENDS IN DEFICITS AND DEBT

Chart 1 shows government revenue and spending trends, as a percentage of GDP, from 1970 to 2010. From 1970 to 1990, the trends show persistent deficits indicating that the budget suffers from structural deficits. The cyclical impact can also be seen as the deficits deepen during recessionary times and are reduced during periods of expansion.

The 1990’s, though appear to be different. Unusually strong economic growth in the 1990’s obviously followed the cyclical pattern of not only reducing the deficit, but actually creating a surplus. While a large part of this is simply due to a favorable business cycle, at least part of this impact is due to pay-as-you-go (PAYGO) financing established by the 1990 Budget Enforcement Act. PAYGO resulted in discretionary spending caps that required reductions in real spending during the 1990’s. PAYGO also required that any tax cuts or increased spending on entitlement programs (the largest being Social Security, Medicare and Medicaid) must be accompanied by spending cuts to offset any projected deficits during the next six years. The PAYGO legislation expired in 2002 which, coupled with economic recession, resulted in sharply increased deficits in the 2009 and 2010.

Deficits and surpluses identify only one-year gaps between revenues and spending, while debt measures the accumulated borrowing of the federal government. Chart 2 shows the debt totals from 1970 to 2010. This basically shows the same trends as the annual deficit data. The growing deficits of the 1980’s resulted in higher overall debt. The budget surpluses in the
1990’s allowed for debt reduction. The recent high deficits, though, have pushed the overall debt to record levels.

**HOW BIG IS TOO BIG?**

Unfortunately, there is no clear answer to this question. Economists generally agree that government borrowing results in slower future economic growth and that these inefficiencies grow at an increasing rate. In other words, doubling the government borrowing does more than double the damage to future growth. While there is no clear consensus on when government borrowing becomes excessive, economists generally agree that the current levels of debt and deficits are not sustainable in the long run.

Data on government deficits and debts as a percentage of GDP are shown in charts 3 and 4, respectively. These charts include data from the members of the Organization for Economic Co-operation and Development (OECD) countries as well as the average across these countries. The current U.S. deficits are above average, and second only to Ireland. This implies that our debt is currently growing faster than our peers. In terms of overall debt, though, the U.S. is approximately at the average of OECD countries. While this does not imply that our debt levels are of no concern, perhaps we can take comfort that we are not alone in this struggle.

**WHAT SHOULD BE DONE TO REDUCE GOVERNMENT BORROWING?**

**Pay-As-You-Go Legislation**

PAYGO legislation was reenacted in February 2010. This legislation demonstrated success in providing fiscal restraint through the 1990’s and should have a similar effect into the future. As the economy recovers, the cyclical component of the deficit should decline; PAYGO legislation will support this response by keeping the structural deficit from growing during the recovery. However, the PAYGO legislation essentially locks in any existing structural deficits in the absence of further adjustments. Thus, while PAYGO will provide fiscal restraint, it will not directly move the government toward a structurally balanced budget.

**Spending Cuts**

One option for reducing structural deficits is to reduce the level of government spending. The big question is where cuts should be made. Historically, elected officials have been hesitant to propose large cuts to Social Security, Medicare, or Medicaid. These three programs account for most of what the Congressional Budget Office defines as ‘mandatory spending’ which accounted for 55% of total government spending in 2010. The other major spending categories are discretionary defense spending (20%), discretionary non-defense spending (19%) and interest expense (6%) (Congressional Budget Office, 2011b). The aging of the baby-boomers, along with rising health care costs, will cause mandatory spending to continue growing based on current legislation for these programs. Thus, if we are going to address deficit and debt reduction seriously, it must include cost-saving reforms for these programs as part of the
solution. Such reforms are also necessary to improve the financial solvency over the long run, regardless of the current debates on deficits and debt.

**Tax Increases?**

The other option for reducing structural deficits is to increase tax revenues. The current political debate is centered on tax cuts, which would be contrary to deficit reduction in the short-run\(^2\). While tax cuts are politically popular, they are perhaps receiving too much attention given the growing debt and deficits. As Chart 1 shows, government revenues are at historically low levels already suggesting that further cuts may not be warranted.

While the political climate currently makes tax increases unlikely, they would provide additional tools to alleviate the deficit. It is my opinion that all options should be at least considered if we are to seriously address the deficit.

**Policy Changes should be Implemented Slowly**

Efforts to reduce deficit spending will require spending cuts and/or tax increases, both of which cause contractions in the macroeconomy in the short run. If successful, they will reap the benefits of future growth by eliminating the negative impacts on private borrowing and reliance on foreign borrowing. Sudden or drastic changes often create overreactions which could send the economy into another deep recession. In order to minimize the short run disruptions to the economy, any changes should be implemented slowly and deliberately, allowing consumers and firms time to adjust to changing economic conditions.

**Shifting Focus to Long-Run Stability**

The final problem that should be addressed is to learn from the recent macroeconomic volatility. If we can achieve a structurally balanced budget, the key to sustaining that balance over the long run is to build up reserves during years with stronger-than-normal growth to offset deficits experienced in slower-than-normal growth years. The natural problem is that we tend to be over exuberant during periods of rapid growth. During the rapid growth in the 1990’s, federal and state governments used those cyclical surpluses to fund tax cuts and spending increases that were simply unsustainable. The prevailing attitude was that we were experiencing a new era of growth to which the old rules did not apply. The cyclical surpluses were mistaken for structural surpluses, based on the erroneous assumption that average annual growth rates had jumped above historical levels.

Thus, to maintain a balanced budget over the long run, we have to resist the urge to increase spending and cut or rebate taxes during years of strong growth. Such restraint is, of course, politically difficult but necessary if we are to smooth out the government budget.

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\(^2\) There is considerable debate on whether tax cuts can stimulate job creating to the point that lower tax rates eventually cause an increase in tax revenue due to income growth. In the short term, such cuts necessarily increase deficits. The empirical evidence on the long-run impact is inconclusive.
REFERENCES


![Chart 1: US Government Revenues, Spending, and Deficits/Surpluses as % of GDP](chart1.png)
Chart 2: US Debt Held by the Public as % of GDP

Source: Congressional Budget Office, 2011

Chart 3: Government Deficits as % of GDP, 2010

Source: OECD Economic Outlook, 2010
Chart 4: Government Debt as % of GDP, 2010

Source: OECD Economic Outlook, 2010