Facts About the Federal Budget and the National Debt

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According to the Bureau of Economic Analysis, federal government expenditures totaled almost $6.4 trillion in 2023, compared to a paltry $375 billion in 1975, almost fifty years ago. Over the same period, however, population grew by 55%, real GDP per person grew by 138%, and the average price level rose by 340%. As a result, federal government expenditures increased an average of 21.3% of GDP from 1975 to 1980, to 23.3% of GDP in 2023. Those who talk about out-of-control government spending are taking these numbers out of context.

By some measures, in fact, the federal government is smaller than it used to be. Relative to our growing population, fewer people work for the federal government in either a civilian or military capacity. Relative to our growing economy,[1] the federal government purchases fewer goods and services than it did fifty years ago.

Figure 1: Federal Employment

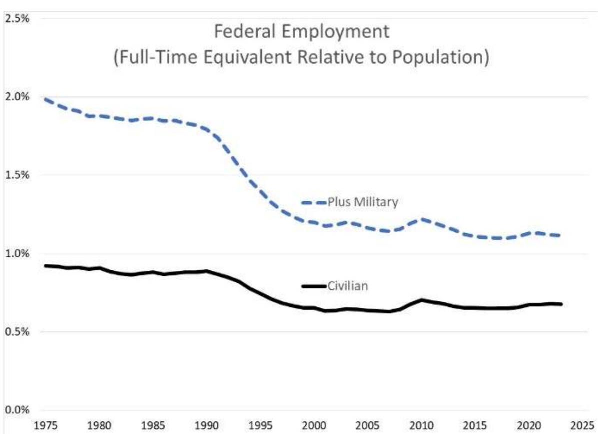


Figure 2: Federal Purchases

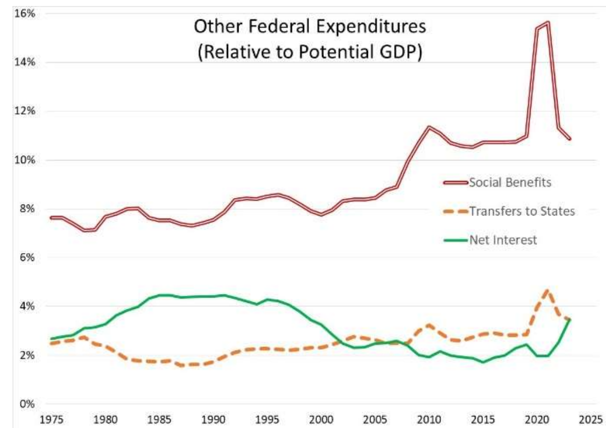
While federal purchases have shrunk relative to GDP, other parts of the federal budget have increased. Primarily these are what we call transfers, since no goods or services are being directly exchanged. Congress considers most of these to be mandatory, rather than discretionary. Social benefits are paid to individuals, usually through social insurance programs that have their own revenue. The federal

[1] In the figure I show this by dividing by "potential" GDP. If I used actual GDP, it would exaggerate the increases during recessions and understate them during booms. Since the point is to show the relative change in the numerator of the ratio, it is best to smooth out the denominator. Adjusting with potential GDP, federal expenditures averaged 21.0% of GDP from 1975-1980, instead of 21.3%.

government also transfers a significant amount of money to state governments through block grants and other programs, to help pay for highway construction, Medicaid, and a variety of other programs. The other significant component of the federal budget is interest on the national debt.[2]

Social benefits paid by the federal government have grown from 8% of GDP in 1975 to 11% in 2023, with a significant spike in 2020 and 2021 as a result of unemployment benefits and other programs during the Covid-19 Pandemic. Social Security accounts for about 45% of these benefits, Medicare for senior citizens accounts for another 28%, and pensions for federal employees, both civilian and military, makes up 12%. Of the remaining 15%, 10% of social benefits are spent on tax credits (e.g., the Earned Income Tax Credit) and food stamps (i.e., SNAP).

Figure 3: Other Federal Expenditures



The pandemic led to a huge increase in spending, as the federal government intervened to help households, businesses, and states through the crisis. President Trump first signed the Coronavirus Preparedness and Response Supplemental Appropriations Act for $8 billion, then the Families First Coronavirus Response Act for $15 billion, the Coronavirus Aid, Relief, and Economic Security (CARES) Act for $2.1 trillion, and the Paycheck Protection Program and Health Care Enhancement Act for $483 billion more. In 2021, after the election, President Biden signed both the Coronavirus Response and Relief Supplemental Appropriations Act for $900 billion and the American Rescue Plan for $1.9 trillion.

Was all that spending necessary? Again, it is easy to imagine ways it could have been better done, but it was done in a hurry, it was needed, and it was well worth the cost. The economic recovery was far faster than virtually anybody expected. But the money supply grew at record levels in 2020 to keep markets functioning while most Americans stopped spending, and OPEC production cuts in 2020 helped to push energy prices up to record levels. These two factors, combined with supply disruptions and a rapid recovery in demand, led to a spurt of price inflation in 2022. Monetary tightening then ended those inflationary pressures.

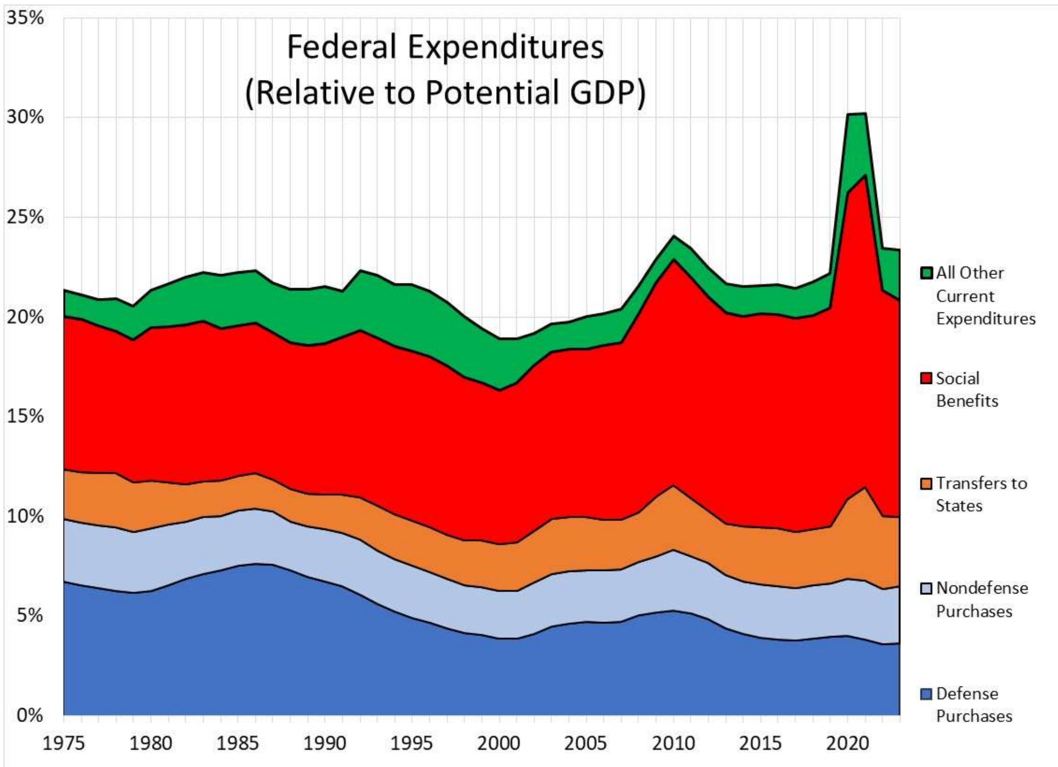
Federal expenditures may be slightly overstated, for accounting reasons. First, a substantial amount of money is collected by the federal government and then transferred to the states, including local governments, school districts, highway funds, Medicaid support, and various block grants. Second, some of the interest on the national debt is paid to the Federal Reserve, and the Fed then returns much of this back to the Treasury. Third, many tax breaks (like the Earned Income Tax Credit, or EITC) are considered

[2] As I will show later, the Federal Reserve System, which acts as the national central bank, holds a significant amount of U.S. Treasury bonds to back up the U.S. money supply. It is paid interest on that debt, but it also returns a significant portion of that interest back to the U.S. Treasury. As a result, in figure 3 I report "net" interest after deducting what is returned to the Treasury.

tax expenditures; that is, they are counted simultaneously as both revenue and expense, even when no money actually changes hands.

Adding purchases, transfers, and interest, we get total federal expenditures. Setting aside the large spikes during the Great Recession and the Pandemic, the upward trend in overall spending is not very significant.

Figure 4: Federal Expenditures



Here are the averages for each part since 1980. On average, the budget deficit would be pretty small without the interest on the national debt, and that debt comes from our past deficits.

Table 1: Average Federal Expenditures, Share of GDP	Average 1980-2023
National Defense	5.2%
Nondefense Purchases	2.7%
Transfers to States	2.5%
Social Benefits	8.0%
Interest on Debt	3.5%
Total Expenditures	21.8%
Federal Receipts	18.1%
Deficit	-3.8%

Social benefits account for the lion's share of the federal budget on average, and most of that is Social Security and Medicare. These two programs have been funded by their own payroll tax revenues put into trust funds that were in turn invested in federal Treasury bonds. Medicaid, on the other hand, is mostly funded through transfers to states, and it lacks a separate income source.

There are two factors behind the growth of Social Security and Medicare. First, the postwar Baby Boom generation began to turn 65 in 2011, and the share of the population in retirement age soon grew by a third. Second, health care expenditures grew faster than GDP, at least until 2009, when the Affordable Care Act passed. Both of these programs were created when both life expectancy and health care costs were much lower. In 1934, when the Social Security Act was passed, the average US life expectancy was only about 62 years. By 1965, when Medicare passed, life expectancy had risen to 70 years. By 2019, just before the Pandemic life expectancy was almost 79 years. With longer retirements, it should be no surprise that the amount collected by the federal government and put into trust funds would not be adequate in the long run.

Figure 5: Life Expectancy and Health Care Costs

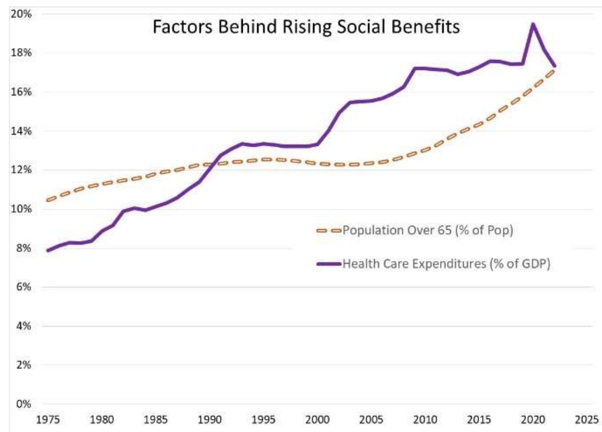
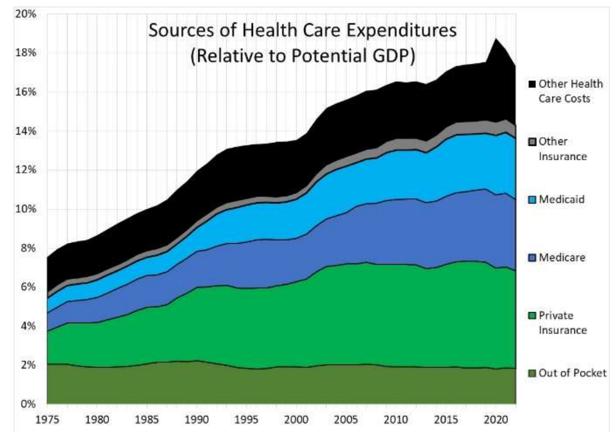


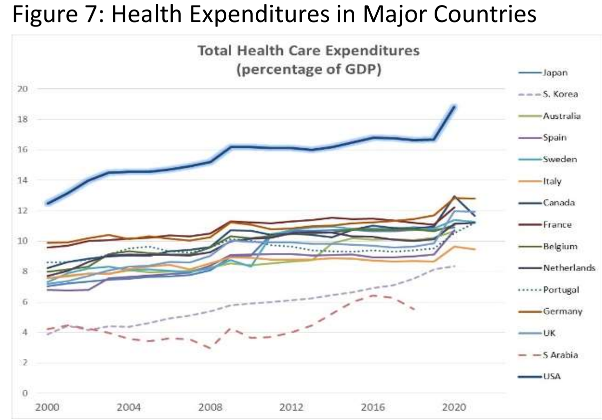
Figure 6: Sources of Health Care Expenditures



But the real driving force is our expensive and inefficient health care system. Americans spend significantly more on health care than virtually any other country in the world, and we get worse results. As Figure 6 shows, government programs make up a large share of total health care expenditures, not only Medicare and Medicaid but also VA hospitals, military health care, and a variety of other programs. Most other developed countries have larger shares paid for by the public sector, but our overall costs are much, much higher.

Figure 7 shows total health expenditures – both public and private – for the U.S. relative to other major developed economies,[3] from 2000 to 2020. We are clearly an outlier. In 1980, the US spent 9% of GDP on health care. This rose to 14% by 2000 and 17% by 2010. We spent significantly more on health care than any other major economy, even though most of those countries have universal health care and a much greater government role that we do. These rising costs predated Obamacare.

Figure 7: Health Expenditures in Major Countries



[3] The comparison group in these graphs is the set of countries with populations of 10 million or more and GDP per capita above $20k in 2022. However, including all countries in the world would still show the U.S. as a significant outlier in health care expenditures.

Is the relative expensiveness of U.S. healthcare being driven by longer lives and an increased share of senior citizens? Comparing the U.S. to other major economies, it does not appear so. Life expectancy was falling behind other developed countries even before the pandemic, and has dropped significantly since then. Other countries have experienced a much faster aging population than we have, in part because they live longer but also because they have less immigration (which tends to include younger people). It is hard not to conclude that not only do we spend more on health care than the rest of the world, but we also get worse results for our money.

Figure 8: Life Expectancy in Major Countries

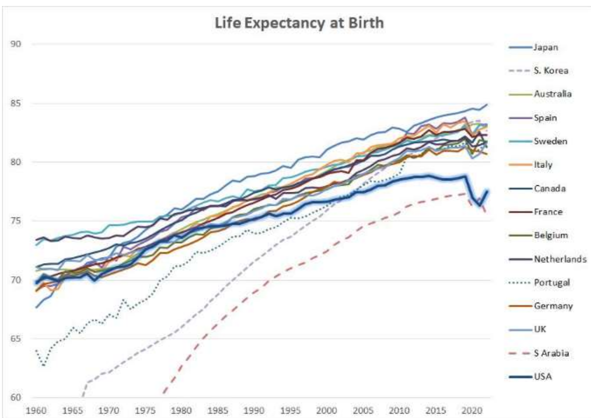
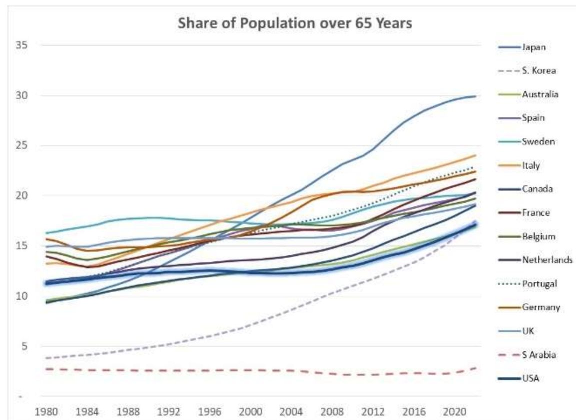


Figure 9: Older Population Share in Major Countries



The federal government of the United States has been called an insurance company with an army.[4] Most government purchases of goods and services are made by state and local governments. Most government purchases are spent on consumption items, primarily the services of firefighters, teachers, courts, and the police, with the rest spent on investments like the construction of roads and schools. The federal government only accounts for 37% of all government purchases, and more than half of that is spent on national defense. Altogether, federal, state, and local government purchases make up only a sixth of U.S. GDP, with the other five-sixths left to the private sector.

Most other countries have more centralized governments, whereas we have a federal governmental structure with significant responsibilities left to the states. Using World Bank data for 2022 allows us to compare our general (i.e., federal, state, and local) government consumption spending to other major developed economies. Looking closely at Figure 10, it is hard to argue with a straight face that our government is excessively large.

Adding back in the social insurance and other expenditures, we see in Figure 11 that total government spending in the US is also low relative to other OECD countries for 2019, the year before the pandemic. Spending paid with receipts is shown in blue, and spending paid for with borrowing is shown in beige. Of

[4] Paul Krugman credits Peter Fisher, an undersecretary of the Treasury in the Bush Administration, with making this observation in 2002.

the forty major economies in the OECD dataset, the US ranked 30th in expenditures, 35th in taxes, and 2nd in budget deficits (after Australia). We have a smaller government relative to GDP than most other developed countries.

Figure 10: Government Consumption Comparison to Other Major Developed Economies

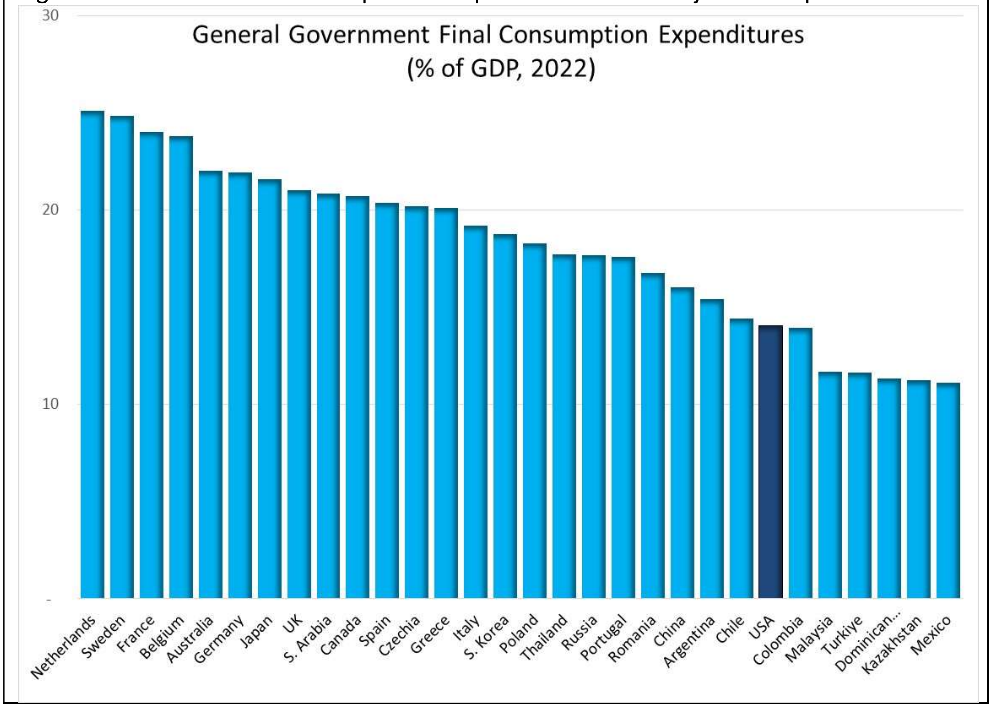
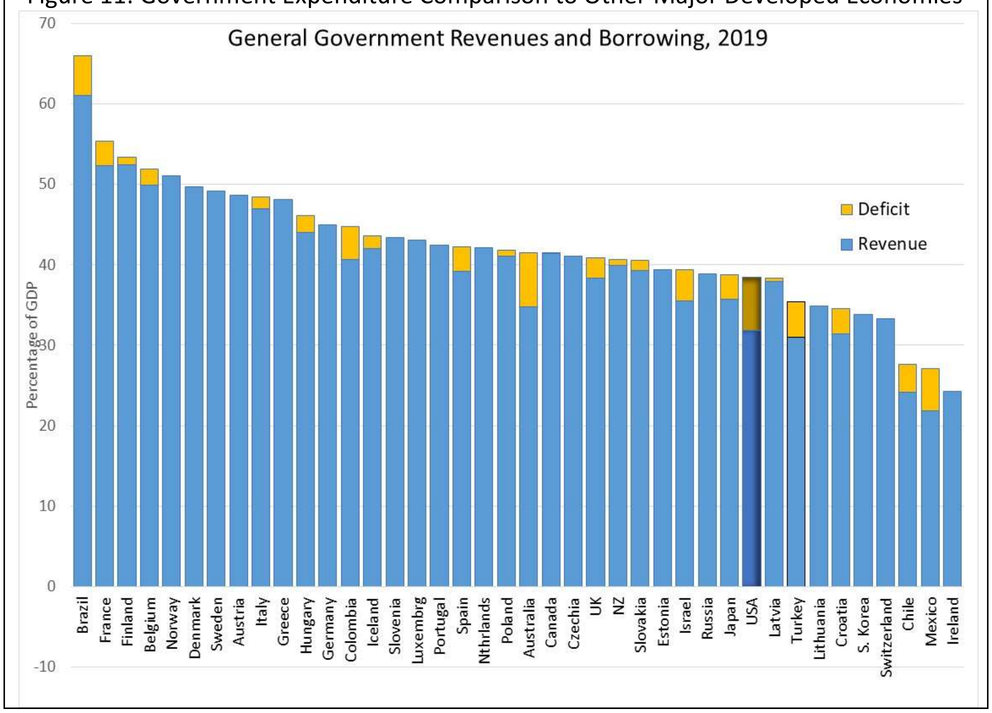


Figure 11: Government Expenditure Comparison to Other Major Developed Economies

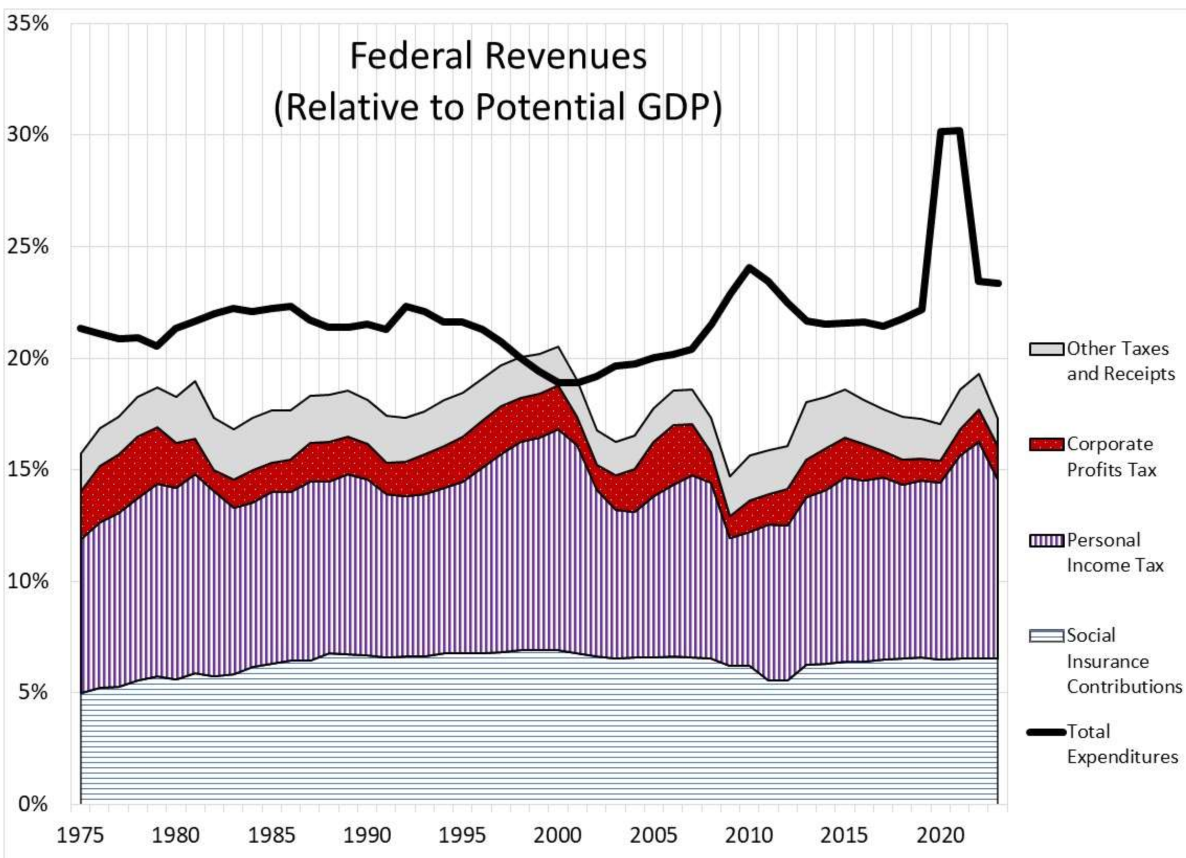


Federal Revenues:

The federal government receives most of its income from individual income taxes and payroll taxes, i.e., social insurance contributions for Social Security and Medicare through FICA (Federal Insurance Contributions Act) deductions. Corporate income taxes have declined significantly over time, but never made up a huge share of federal revenues. Miscellaneous excise taxes, customs duties, investment income, and occasional property sales make up the remainder. It is clear from Figure 12 that federal receipts have failed to keep pace with expenditures for over forty years. The difference is known as the budget deficit.

During and after WWII, there was a basic income tax rate of 3% plus a surtax on the highest earners that increased the top marginal tax bracket to 91%. In 1964, however, President Johnson pushed through the so-called "Kennedy" tax cuts to reduce the top rate to 70% for unearned income. This was one of the only times that a significant tax cut was followed by faster economic growth and an increase in tax revenue relative to GDP. The lesson learned from this event would then be applied over and over again, without success.

Figure 12: Federal Revenues compared to Federal Expenditures



In 1981, President Reagan proposed a substantial increase in military spending along with a major cut in tax rates (called the Economic Recovery Tax Act), and he promised it was possible to do both without raising the deficit. Arthur Laffer, his advisor, famously drew a "Laffer curve" on the back of the napkin to show how cuts in tax rates might result in increased tax revenue, but the theoretical underpinnings of this were based more on wishful thinking that rigorous analysis. Tax collections grew more slowly than inflation, and much slower than the economy.

Did Reagan's advisors really believe that you could cut taxes, increase spending, and still balance the budget? Arthur Laffer did, but most others – including his own budget director, David Stockman – did not. Some argued that there was an intentional strategy to "starve the beast" to create deficits that would force Congress to eventually cut government programs. But whether intentional or not, elected Republican officials learned that voters and big donors liked tax cuts, but not spending cuts to programs they cared for, like Social Security, Medicare, and most everything else the federal government provides.

Five years later, President Reagan pushed through a "tax reform" package that substantially reduced the top marginal rate on high-income individuals, corporate tax rates, and the tax on capital gains. The top income tax rate dropped to 31%, and deficits rose to levels not seen since WWII. Since the top 1% of income earners receive most of their income through capital gains, dividends, and other business income, while the other 99% receive most of their income through wages and salaries that were also subject to payroll taxes, this also contributed to a growing level of income inequality in the United States.[5]

When President Clinton came into office in 1993, the Deficit Reduction Act was passed without a single vote from Republicans.[6] Taxes on the top earners rose, military spending came down, and contrary to Republican warnings the economy grew more than twice as fast during Clinton's eight years in office than it did in the eight years prior or the eight years after.

By 2000 chronic budget deficit turned into a surplus. Clinton's Vice-President Al Gore ran for President in 2000 on the platform of continuing Clinton's policies, and even talked about a "lock box" of set-aside savings to ensure the long-term health of Social Security. Republicans mocked him for it, and George W. Bush proposed tax cuts instead. Alan Greenspan, Chairman of the Federal Reserve Board, testified before Congress in 2001 that it was a bad idea to pay down too much of the national debt, and he argued that tax cuts were necessary to prevent that.[7]

Two big tax cuts were passed, and our chance for bringing down the national debt was lost. Many of the Bush tax cuts were delayed in order to understate their impact on the budget deficit, so several went into effect just as the Great Recession was starting. Deficits grew substantially. The invasion of Iraq increased military spending, making the deficit even larger. Bush called for a third tax cut in Spring 2008 that had very little effect on the economy, and then tax collections plummeted in Fall 2008 as the financial system

[5] Warren Buffett, the famous investor, pointed out in 2012 that his secretary, Debbie Bosanek, paid a tax rate of 35.8% of income, while Buffett himself paid only 17.4%.
[6] The Deficit Reduction Act was otherwise known as the Omnibus Budget Reconciliation Act of 1993, and it increased the marginal tax rates on the top 1.2% of earners to 39.6%.
[7] See https://www.washingtonpost.com/archive/politics/2001/01/26/greenspan-supports-a-tax-cut/72f4925a-96d5-4120-8e0a-264a3d1d7476/.

started to collapse and unemployment rates rose. In 2009, newly-elected President Obama signed the American Reinvestment and Recovery Act, which added significantly to the deficit.

The stimulus was designed more to pass Congress than to get the most bang for the buck. A third of the ARRA was tax cuts, and these weren't very effective since most of those who got them just saved the money. A third went for education and health bailouts to the states, and these would have worked better if they had gone to the hardest-hit states instead of mostly to the states with the most ready cash for matching federal block grants. Finally, a third of the extra spending went for infrastructure, but the number of "shovel ready" projects was small and the approval process for federal spending projects took years. There was also a short-term cut in the FICA payroll tax that did help those most likely to spend the money.

Was this stimulus necessary? Most economists would agree that it was, as the cost of the intervention was dwarfed by the lost output from the recession. The recession was bad, but it could have been much, much worse without intervention. But the stimulus was also short-lived. Once Republicans regained control of Congress in 1993, sequestration and budget cuts followed. Many credit this tightening with the slow recovery during the Great Recession, and the economy did not catch up to its pre-recession level until 2014.

Trump and the Republicans took power in 2017, and by the end of the year they passed new tax cuts. These included raising the standard deduction, which reduced income taxes for those at the lowest end and reduced the incentive to itemize for many households, but most of the tax savings went to those at the upper end and the corporate tax rate was cut the most.

Government tax revenues are not only driven by policy, they are also very sensitive to recessions. Over the last fifty years, the NBER identifies seven recessions, with contractions averaging 11 months from peak to trough. Table 2 shows these recessions, along with the duration from prior peak to trough, the percentage change in government tax revenues, and the change relative to GDP.

Table 2: Effects of Recessions on Government Tax Revenue

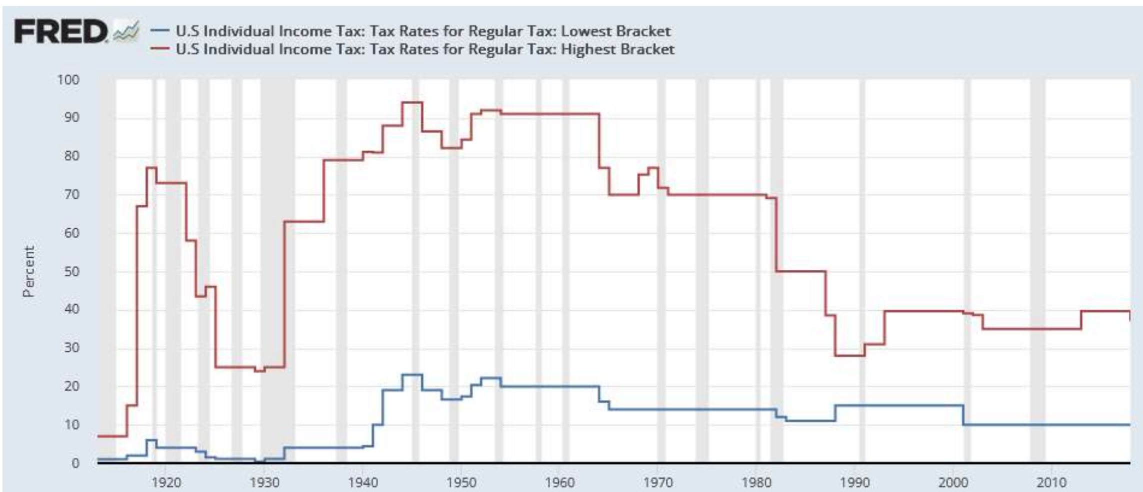
Peak-Trough	Months	Related Event	Change	% of GDP
1973:4-1975:1	16	OPEC Oil Crisis	-8.2%	-2.3%
1980:1-1980:3	6	Iranian Revolution	-2.2%	-0.6%
1981:3-1992:4	16	Monetary Tightening	-8.9%	-2.5%
1990:3-1991:1	8	Iraqi Invasion of Kuwait	-2.5%	-0.7%
2001:1-2001:4	8	Tech Bust, 9/11	-6.9%	-2.1%
2007:4-2009:2	18	Housing Bust, Great Recession	-16.7%	-4.8%
2019:4-2020:2	2	Pandemic	-6.5%	-1.8%

State and local governments are generally constrained to keep a balanced budget in their current revenues and expenditures, although unlike the federal government they usually maintain a separate capital budget they can finance through bonds. The downside of this, of course, is that state and local governments are forced to raise taxes or cut spending during recessions, actions that can make recessions even deeper.

The federal government, on the other hand, can borrow to cover its current deficits by issuing Treasury bonds and adding to the national debt. When those securities are purchased by the central bank with newly created money, that essentially "monetizes" the debt. If the money supply created by the central bank grows faster than the overall economy, inflation results. To prevent a direct linkage between budget deficits and money creation, the US created the Federal Reserve System (i.e., the "Fed") in 1913 as a quasi-autonomous central bank with its own independent source of revenue. The Treasury pays interest to the Fed, and the Fed returns its excess earnings back to the Treasury.

Figure 13 shows both the highest and lowest federal income tax rate for personal income. Most people are in the lowest brackets. Federal individual income tax collections averaged 7.5% of GDP between 1950 and 1963, and 7.9% between 1965 and 1980.

Figure 13: Top and Bottom Tax Brackets



There has also been a shift in the tax burden away from the rich, not only in corporate taxes but also in personal taxes. Here are two graphs both showing average personal and corporate tax rates, that is, the amount of personal income tax actually collected divided by personal income before tax, and the amount of corporate income tax collected divided by corporate profits before tax. Figure 14 below on the left shows this for annual data, 1950-2018, and also shows the top marginal rate for the richest taxpayers. The right graph zooms in to show these averages for 1980-2023 using quarterly data.

Corporate income (profits) tax collections (shown in blue) have fallen significantly over time, and a relatively small compared to those paid by individuals. This decline in tax receipts has happened even as corporate profits have grown by 50%, from an average of 8% of GDP in the 1980s to 12% over the past decade. The grey area is everything else, and you can see a funny little spike in 2017 that has to do with corporations moving funds back from overseas to take advantage of the Trump tax cuts. Altogether, there is a very slight downward trend in federal receipts of about 0.1% per decade. That is, federal tax receipts over the last forty years have not quite kept pace with the economy, and have certainly not kept pace with expenditures.

Figure 14: Top and Average Tax Rates, 1950-2018

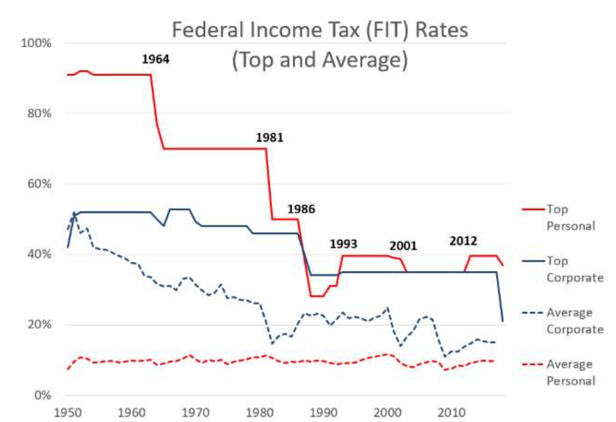
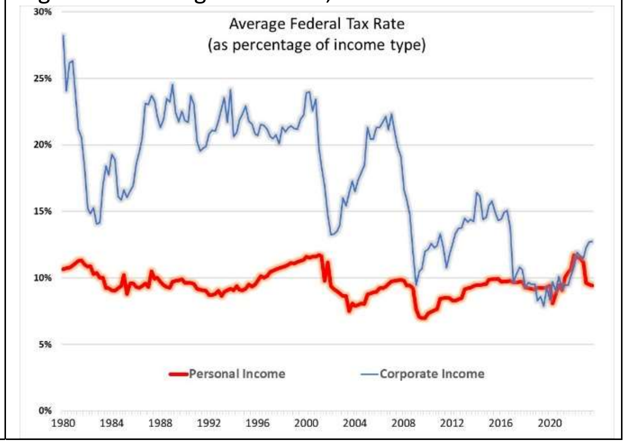


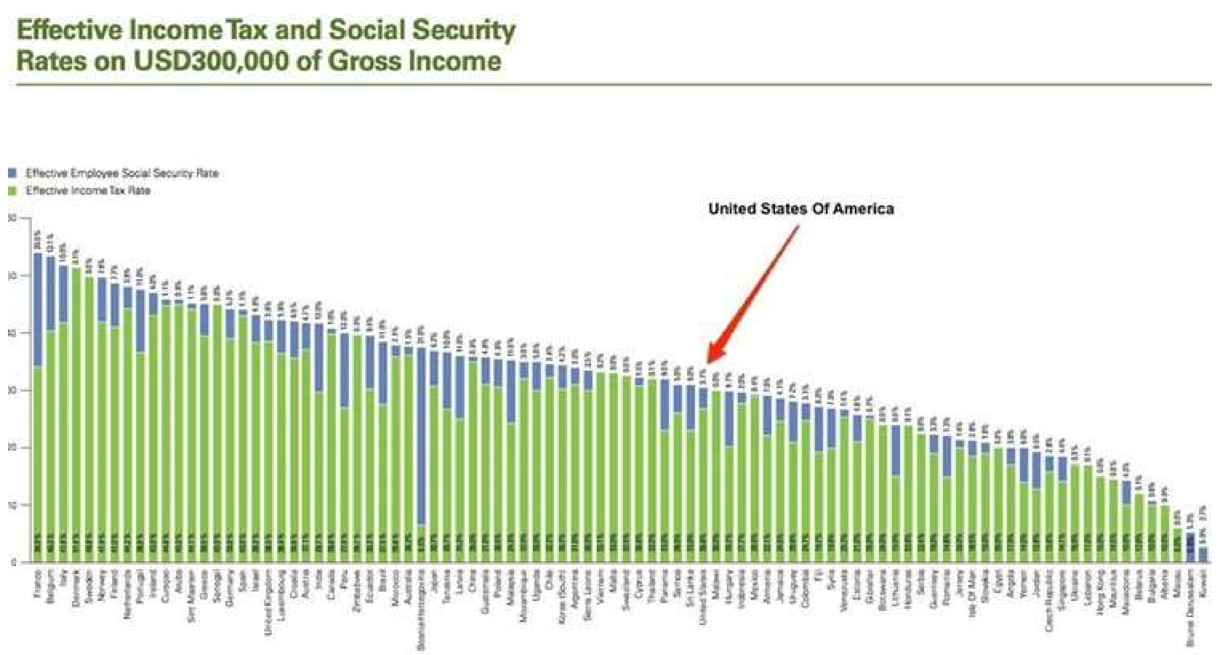
Figure 15: Average Tax Rates, 1980-2023



Over the last five decades, average personal tax collections haven't changed that much, but corporate profits taxes have fallen dramatically over time. Trump recently promised he would cut them even further if re-elected. The little jump up in 2021-22 is due to the rapid economic recovery from the pandemic, especially on income from capital gains. Higher interest rates then cooled the stock market in 2023.

Corporate income used to be taxed at a much higher rate than personal income, but that difference has disappeared. Meanwhile, average personal income tax rates have remained relatively steady, even as the top rates have come down. If the average personal tax rate has stayed more or less constant while the top rate has fallen, that means that somebody other than the rich are paying relatively more.

Figure 16: Average Tax Burden Across Countries



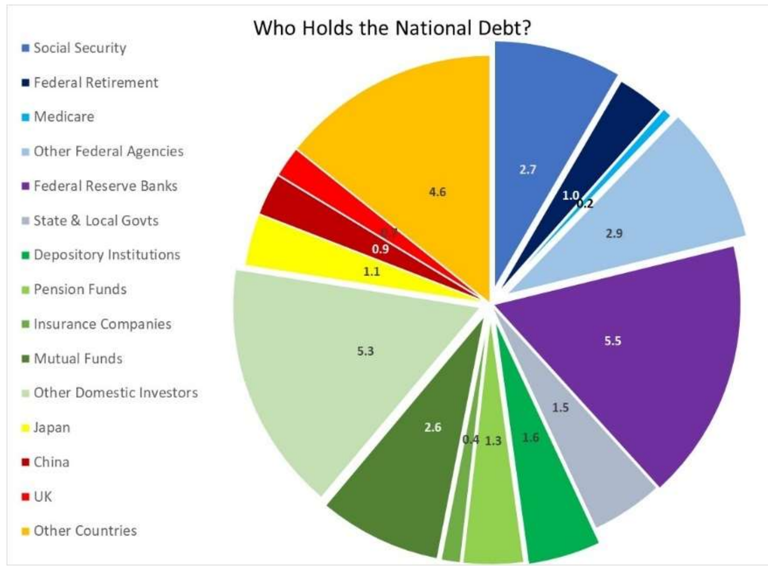
How does the tax burden for a well-off taxpayer compare to other countries? Figure 16 above (which I borrowed) shows the relative tax burden prior to the pandemic for an individual earning $300,000 per year, and it includes both income taxes and social insurance contributions. Once again, the USA does not seem to have high taxes relative to the rest of the world.

The Federal Debt:

If expenditures exceed tax revenues, the resulting budget deficit has to be covered by Treasury borrowing. Some of this debt, however, is held by federal agencies and trust funds, and so is money owed by the federal government to itself.

As of July 2023, the Federal Government has a gross national debt of $33 trillion, a figure equal to 120% of the annual GDP of the US economy. However, 21% of this gross debt is held in Social Security trust funds, the retirement system for federal employees, and other federal government agencies. The rest is said to be held by the public, but that includes 17% that is held by the Federal Reserve System to back up the US money supply, and another 5% that is held by state and local governments.

Figure 17: Federal Debtholders



Subtracting those amounts leaves us with $18.4 trillion, about two-thirds of US GDP. About 34% of the gross national debt is held in the portfolios of mutual funds, insurance companies, banks, and other American firms and individuals, since US Treasuries have long been considered one of the safest assets in the world.[8] The remaining 23% is held by foreign central banks and other foreign investors, with Japan, China, and the United Kingdom being the largest foreign holders of US federal debt. Many central banks invest their monetary reserves in US Treasuries, and have done so since the postwar Bretton Woods system made the US Dollar the world's reserve asset. Most international transactions are still conducted in Dollars, even when the transaction is between two other countries with their own currencies.

The last time the national debt exceeded our annual GDP was right after the Second World War. We didn't actually pay the debt off afterwards, as Figure 18 from Federal Reserve Economic Data (FRED) shows. Instead, we raised taxes to cover spending and we let the economy grow out of the debt. The debt started growing again in the 1970s, due to price inflation and a worldwide recession in the mid-1970s, but the resulting deficits were around the size of the nominal growth of the economy so the ratio remained stable.

[8] This has been the case since Alexander Hamilton was Secretary of the Treasury, and the reputation effect was a major reason he advocated that the federal government should assume the revolutionary war debt of the original 13 states.

Figure 19 shows how the debt/GDP ratio fell until the 1970s, and then started rising in the 1980s after the Reagan tax cuts.

Figure 18: National Debt, 1940-1990

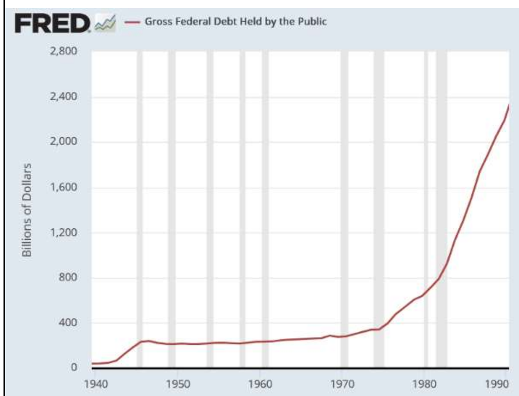
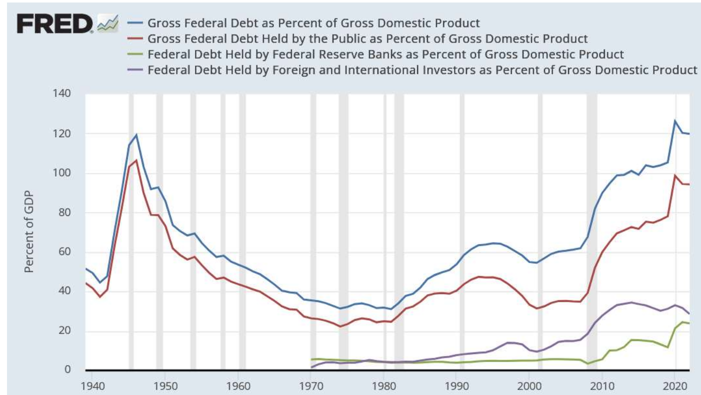


Figure 19: National Debt Relative to GDP



In Figure 19, the red line shows the debt held by the public, including the debt held by the Federal Reserve system (in green) and foreign investors (in purple). Since 1980, the federal debt grew faster than GDP except for the last half of the Clinton years, and the federal debt is now relatively high compared to most other major countries. The debt held by the public is still a lower percentage of GDP than it was after WWII, which suggests that a similar policy could have a similar result.

The Federal Budget:

What should the federal budget look like? Reasonable people can disagree. Some want more spending, some want less, some want more of some things and less of others. Every large organization has waste, especially when politics are involved, and we may disagree on where the government should spend what money they have. But either way, we need expenditures and revenues to generally line up.

Many people like the idea of a balanced budget, perhaps enforced through a constitutional amendment. However, most economists generally think can be a bad idea in the short term. One does not have to be a Keynesian economist to understand that deficits will naturally occur during recessions, since unemployment benefits will rise and tax collections will fall, so that cutting spending or raising taxes during a recession could make the recession worse. Furthermore, an increase in public spending can help offset a decrease in private spending, and in deep recessions this could make the recession even worse.

One option economists have advocated is to balance the “full-employment” budget, i.e., what the budget would have been without the recession, so that the budget is roughly balanced over the business cycle. Another alternative is to separate the capital budget from the current budget, so that current investments can be balanced off against future returns, and even to create the federal equivalent of a “rainy day” fund so that quick intervention during downturns is possible.

In fact, stabilizing the national debt does not even require a balanced budget, as long as the economy is growing. For example, if the economy grows by an average of 4% per year (including 2% inflation and 2%

real growth), then a debt that grows by less than 4% per year (including interest) will lead to a falling debt burden over time. Getting interest rates back down would help, of course.

At present, however, we continue to run large federal budget deficits even when the economy is growing strong. What we collect for social insurance is not currently enough to pay for social benefits, and the trust funds for Social Security and Medicare are declining rapidly. Our tax receipts currently are not enough to keep up with our high health care costs and our aging population.

Republicans say the reason is too much spending, but the spending cuts they demand are relatively focused and insufficient, given that most Republicans don't want voters to see them cut Social Security, Medicare, or National Defense. Democrats say the answer is that the rich don't pay enough in taxes, but they haven't been able to raise tax rates significantly since 1993 since Republicans have been able to block any tax increases with filibusters. This political stalemate means that budget deficits will only continue.

Differences by Party:

Table 3 compares GDP growth and the change in receipts and expenditures as a share of GDP, for the 12 presidential terms since 1976, six of them Democratic and six of them Republican. On average, the economy has grown a little faster under Democratic administrations (11.8% real growth per four-year term) than under Republican administrations (10.4%). Federal receipts tend to grow under Democrats (by +0.7% of GDP per term) and fall under Republicans (-0.7% of GDP per term). Federal expenditures tend to shrink under Democrats (by -2.0% of GDP per term) and rise under Republicans (+2.2% of GDP per term). While this is not conclusive proof, given the many things that can happen that are not under the President's control, it is still ridiculous to conclude that Republicans are more likely to balance the budget than Democrats.

Table 3: Growth and Budgets By Administration

Democratic Administrations:	1976-1980 Carter	1992-1996 Clinton	1996-2000 Clinton	2008-2012 Obama	2012-2016 Obama	2020-2023* Biden	Avg
Real GDP Growth	13.6%	13.9%	19.0%	3.9%	9.7%	10.6%	11.8%
Federal Receipts (% GDP)	1.5%	1.3%	1.1%	-0.9%	1.8%	-0.4%	0.7%
Federal Expenditures (% GDP)	0.2%	-1.6%	-2.6%	1.5%	-1.3%	-8.0%	-2.0%
Surplus/Deficit (% GDP)	1.2%	2.9%	3.8%	-2.4%	3.1%	7.5%	2.7%
Republican Administrations:	**1980-1984 Reagan**	**1984-1988 Reagan**	**1988-1992 Bush I**	**2000-2004 Bush**	**2004-2008 Bush**	**2016-2020 Trump**	**Avg**
Real GDP Growth	12.9%	16.2%	9.2%	9.6%	8.6%	5.7%	10.4%
Federal Receipts (% GDP)	-1.1%	0.8%	-0.7%	-3.6%	0.9%	-0.7%	-0.7%
Federal Expenditures (% GDP)	0.7%	-1.0%	1.4%	1.2%	1.9%	9.3%	2.2%
Surplus/Deficit (% GDP)	-1.8%	1.8%	-2.1%	-4.8%	-1.0%	-10.0%	-3.0%

* Biden's term is incomplete.

What if We Default?

Frustration with the ongoing deficits have led some Americans to wonder if we could just renounce the debt and start over. Setting aside the morality of not living up to your promises, the first problem with this approach is that it is unconstitutional.[9] Nonetheless, Congress has recently come within days of not being able to cover debt payments, since they must vote separately to increase the debt ceiling even though they also voted on both the revenues and expenditures in the budget. It is a line that they have yet to cross and a decision the Supreme Court has been able to avoid so far, but it is certainly plausible.

It is not practical to stop paying interest, since most of the debt is currently issued in the form of discount bonds. The purchaser of the debt lends the federal government an amount less than the face value, and makes their money in the gap. A six-month Treasury Bill with a face value of $10,000 currently sells for about $9740, so the investor will earn $260 over the next six months. Renouncing the interest would not change what we owed, but it would mean that no investor would be willing to buy the next Treasury bills the federal government sold. Since the debt churns, so that past short-term debt is always repaid with new debt, this would quickly force an unconstitutional default.

The economic repercussions to the US economy would be enormous. Social Security, Medicare, government pension programs, and the Federal Reserve System would immediately become bankrupt. Similarly, commercial banks, insurance companies, mutual funds, and many other firms that manage investments would collapse. Banks would stop lending and start calling in their loans.

The catastrophe this would cause would rocket around the world. Central banks that back up their money supplies with US Treasuries would face similar problems, and the trillions of dollars that flow each day through foreign exchange markets would freeze up as the Dollar no longer could be used. The trillions of dollars held around the world would be soon sold off, and the value of the Dollar would plummet. The Fed would likely have to buy up some of the excess, and the result would be a large jump in price inflation. The consequences could be similar or even worse than those of the Great Depression that began in 1929, except there would be nobody to help with the recovery.

Even if we could survive the consequences, what happens once our credibility has been lost? Credibility is essential to borrowing, and borrowing will always be necessary if the nation is to survive wars and recessions. Countries like Argentina that have defaulted forever find themselves paying very high interest rates to borrow, and they lurch from one economic crisis to another because of it.

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[9] The 14th Amendment, passed in the aftermath of the civil war, tried to address any future effort to renounce the national debt. Section 4 says, "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."

The long-term consequences would continue throughout our lifetimes. Over more than two centuries, US Treasuries have become the world's safest asset, and the loss of this trust could severely reduce our standard of living for decades to come. The risks are simply too great to risk.

Some have suggested that we should force the Federal Reserve to simply buy up and hold the debt held by the private sector. Because the interest paid to the Federal Reserve is mostly refunded to the US Treasury, this seems like it might have some advantages. Far from being an easy solution, of course, this would more than triple the money supply. Doing it gradually would mean years of higher inflation, and that would in turn cause higher interest rates. Doing it quickly, the resulting inflation would be even more dramatic because it would immediately push people to shed their dollar holdings, resulting in price inflation that would far exceed 300%. This would not only wipe out the savings of those Americans with money, but this would also immediately push those without savings into deep poverty as prices would jump much faster than their wages.

In the end, the most practical thing to do is to raise taxes so that the average difference between federal expenditures and federal revenues is small, small enough that the national debt no longer grows faster than the economy. We can allow significant deficits during bad times as long as we also run surpluses during good times to pay off some of that debt. We were able to do this during the Clinton Administration, and with a political willingness to compromise and put the national interest over the partisan interest, we could do so again.

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