Policy Connection

What policies are responsible for the national debt?

DOMESTIC POLICY

The Policy Challenge

In this chapter, we discussed the role played by Congress in managing the national economy by matching revenue intake and expenditures. At the heart of this annual problem is the question of the **national debt**—that is, the total amount of money the federal government owes as a result of having spent more money than it has received in revenues. Each year, the federal government accumulates either a **budget surplus** (when its revenues, or receipts, exceed spending, or expenditures) or a **budget deficit** (when expenditures exceed revenues, or receipts). Over the past few decades, the government has generated a budget surplus only in 1998 and 1999; as a result, the national debt has increased almost every year since at least the 1970s.

Debates over the national debt or the annual budget deficits that add to it involve a good deal of finger-pointing, as politicians attempt to blame one another for the perceived problems associated with the debt. In this Policy Connection, we avoid the issue of who creates the national debt and, rather, focus on what policies tend to sustain the debt at its seemingly astronomical levels.

The Debt Itself

We begin by noting that the very existence of the U.S. national debt was the result of a policy decision made by the Constitution's Framers as they met in Philadelphia.[43] During the American Revolution, the Continental Congress accumulated a substantial debt, and by 1781 the collective debt of the rebellious colonies was already a concern. The congress under the Articles of Confederation had no power to tax; thus, it could not make much headway in paying off that debt other than by selling the western lands under its control and pleading for the states to assume responsibility for a portion of the debt. Although those efforts did reduce the debt somewhat, the nation's poor credit and the constant threat of bankruptcy were key factors leading to calls in 1787 for the Philadelphia convention that was to address the problem.[44] It is not surprising, therefore, that payment of the public debt was among the first in the list of powers granted Congress in Article I, Section 8, of the Constitution.[45]

The idea of an ongoing national debt has always drawn criticism from those who believe that debts should be paid off as soon as possible and budgets balanced each year.[46] In addition to regarding debt as an inherently bad thing, opponents of debt argue that the government's debts compete for credit with private debt that could be more productively used for investments and consumer purchases that energize the economy. Moreover, a national debt imposes a burden on future generations who might not benefit from today's spending.

Supporters of policies that maintain the national debt counter that the federal government's debt (called U.S. "sovereign debt" in global financial markets) is very different from personal or household debt and that a longer-term perspective is necessary. As a form of debt, U.S government bonds are perceived as the global standard for a safe investment. Supporters also note that, each year, the government—directly or indirectly—provides funding for programs that can have significant payoffs in the future (e.g., spending on research in health care and space technology and support for education, including subsidizing student loans) and are therefore investments that will benefit, rather than burden, future generations.

Another concern about the national debt is the fear that it makes us vulnerable to decisions by the country's creditors, especially foreign creditors such as the Chinese government. Although foreign and private creditors hold a substantial portion of America's national debt ($19 trillion by August 2016), the major creditor is actually the U.S. government itself, which borrows from various trust funds and other pools of government money (see Table 11PC.1). Although $5.9 trillion is owed to foreign sources, clearly much more of the debt is held domestically.[47]

Tax Expenditures

Many of us think of the deficits as the result of the government spending too much, but there is also the possibility that government generates too little to pay for public programs and services. In short, deficits and the national debt grow because we do not tax ourselves enough.

The idea of reducing deficits and the debt by raising taxes meets considerable resistance in the U.S. Congress, especially in recent years, when many members have signed no-tax-increase pledges.[48] Alternatively, revenues could be increased by reducing or eliminating tax breaks that provide government support for certain types of activities by partially or completely exempting such activities from taxation. These tax breaks are not merely a relief from the burdens of taxation; they are an indirect means for government to support some private-sector activity—or **tax expenditures**. In other words, certain provisions of the U.S. tax code are really spending programs masquerading as tax breaks (see Table 11PC.1).[49] In 2015, tax expenditures amounted to an estimated $1.1 trillion—more than the amount of money spent by the federal government through discretionary expenditures (see the following discussion).

TABLE 11PC.1 Exceptions to the Normal Tax Structure

Tax expenditure*	Description	Examples
Exclusion	Excludes income that would otherwise constitute part of a taxpayer's gross income	Employees generally pay no income taxes on contributions their employers make on their behalf for medical insurance premiums
Exemption	Reduces gross income for taxpayers because of their status or circumstances	Taxpayers may be able to reduce their tax liability if they have a dependent who is a child age 19 through 23 and is a full-time student
Deduction	Reduces gross income as a result of expenses taxpayers incur	Taxpayers may be able to deduct state and local income taxes and property taxes
Credit	Reduces tax liability dollar for dollar; additionally, some credits are refundable, meaning that a credit in excess of tax liability results in a cash refund	Taxpayers with children under age 17 potentially can qualify for a partially refundable, per-child credit of up to $1,000, provided their income does not exceed a certain level
Preferential tax rate	Reduces tax rates on some forms of income	Capital gains on certain types of income are subject to lower tax rates under the individual income tax
Deferral	Delays the recognition of income or accelerates some deductions otherwise attributable to future years	Taxpayers may defer paying tax on interest earned on certain U.S. savings bonds until the bonds are redeemed

Source: U.S. Government Accountability Office.

**This includes the types of tax expenditures that are identified in the Congressional Budget and Impoundment Act of 1974.*

The best-known tax expenditures are those dealing with homeownership. There are a number of rationales for promoting homeownership, including the role it plays in enhancing a family's wealth and status and in facilitating the market for new home construction and all the economic activity associated with it. The government has a number of policies to promote homeownership, including direct assistance to those who qualify for public subsidies and low-interest loan programs through various government agencies (the best know being FHA loans from the Federal Housing Administration). But by far the most significant program involves allowing tax deductions for mortgage interest and property taxes, as well as special tax treatment for those who rent their properties or use them to conduct business. The home mortgage interest deduction alone cost the federal government an estimated $95.5 billion in foregone revenues in 2016.[50]

Home mortgage interest deductions are only one of many tax expenditures, some involving tax credits (e.g., credits for biodiesel producers and energy-efficient appliances), tax exclusions (e.g., for scholarship and fellowship income and self-employment medical insurance premiums), or tax deferrals (e.g., deferrals of interest on U.S. savings bonds or income on life insurance annuities). The bottom line is that these many (literally hundreds) tax breaks have a major impact on the annual deficit and therefore the national debt.

Mandatory Spending and Entitlements

Mandatory spending includes both entitlement programs and government spending obligations that are not subject to the annual government appropriations process.[51] As we discussed in Chapter 11, entitlement programs, such as Social Security and unemployment benefits, commit the government to supplying funds or services to all citizens who meet specified eligibility requirements set in law. Because the amount of money spent depends on the number of people who meet those standards, this spending is uncontrollable from year to year unless the requirements change. For example, as more people reach retirement age or as more become unemployed during a recession, government spending increases without any congressional or executive action.

The same mandates are true for obligatory spending, such as payments to veterans and federal government retirees and obligations assumed under guaranteed loan or other federal insurance programs (e.g., claims made under bank deposit insurance, crop insurance, and student loan defaults). Interest payments on the national debt are also regarded as mandatory obligations. The government has no choice but to spend the required amount.

Discretionary Spending

Another component of government spending adding to the national debt are those programs and policies that are subject to funding through the annual appropriations process, in which Congress sets the level of funding—what policymakers in Washington call **discretionary spending**. After we take into account mandatory spending (including interest on the federal debt), less than one-third of the annual federal budget falls under the discretionary category.

Those critics who are anxious about the growing national debt—sometimes called "deficit hawks"—frequently call for reductions in tax expenditures and entitlement programs, but because they are politically difficult to change, discussions often turn to reducing the federal budget by cutting back on discretionary spending. But cuts in these programs can also be difficult. Nearly two-thirds of discretionary funding is appropriated for defense and national security programs that are rarely subjected to major cuts. The rest is distributed among hundreds of different programs, from the National Parks and the Forest Service to the Centers for Disease Control and Prevention and the Bureau of Labor Statistics. Discretionary spending cuts also affect government grants to states and localities, as well as federal funding for research.

One recent approach to reduce discretionary spending is **budget sequestration**, a process in which Congress agrees to cap expenditures within a broadly defined category of spending. In the Budget Control Act of 2011, automatic sequestration was to be triggered unless members of Congress agreed on a significant deficit-reduction plan. Because no agreement was reached by March 2013, $42 billion in sequestration cuts were implemented across many discretionary-funded programs.

It's Complicated . . .

Attempts to reduce discretionary spending raise the question of why these government programs exist—that is, why Congress decided to spend money on these programs to begin with. The answer is complicated because each government program is the product of many historical and political factors. Major crises such as wars or severe economic recessions produce demands for government action; although many of the programs created in response disappear after the crisis passes, others do not.

Major economic crises can have the same impact as wars on long-term discretionary spending. In response to the Great Recession of 2008, in 2009 Congress approved a $787 billion economic stimulus package (the American Recovery and Reinvestment Act) that included $357 billion to be spent on discretionary-funded programs.[52] Another source of discretionary spending is pork-barrel legislation and earmarking, discussed in Chapter 11. After Hurricane Sandy devastated communities along the New Jersey and New York coast in 2012, for example, a bill to provide more than $60 billion in emergency funding made its way to final passage in early 2013. By the time the measure was ready for a vote, it contained provisions to fund road-improvement projects in states not impacted by the storm as well as subsidies for Alaskan fisheries and funding for repairs of the roof at Washington's Smithsonian Institution, construction work at the Guantanamo Bay prison facilities in Cuba, and repairs at the Kennedy Space Center in Florida—all probably worthy expenditures, but not germane to the rationale for the Sandy relief bill. "Every disaster," commented the *Wall Street Journal*, "has become a political opportunity,"[53] and in Congress that has meant an opportunity to add funding for one's pet project.

Most discretionary funding, however, provides for the bulk of public goods and services that have been given due consideration through the legislative process. The need for a local post office or funds to help construct science classrooms or support a homeless shelter are part of what adds to government expenditures and often to increases in the national debt.

Conclusion

What policies are responsible for the national debt?

The debate surrounding America's national debt is as old as the country itself, and it is unlikely to disappear from the halls of Congress or the media in the foreseeable future. It does help, however, if we understand what the debate is about. As we have seen from this general overview of the policy sources of the debt, the challenge may be not to reduce or eliminate the debt (or the annual deficits that feed it) but rather to establish a policy for managing the debt that fulfills Hamilton's goal of using it for positive purposes.

QUESTIONS FOR DISCUSSION

1. **It is obvious to those calling themselves "deficit hawks" that the main challenge in the effort to reduce the national debt is to control mandatory entitlement spending. But major entitlements such as Social Security and Medicare make up nearly half the annual budget and are politically difficult to change. If you were in a position to decide where to cut spending, which programs would you focus on? National defense? Social services and income-security programs such as school lunch programs? Support for K–12 education programs? Support for higher education?**
2. **"It's a good thing our grandparents didn't worry about burdening their grandchildren with government debt. If they didn't spend all that money on highways, schools and hospitals we'd be in pretty sad shape right now." Do you agree or disagree with that statement? Should our grandparents have been more concerned about the debt they have passed on to us? How concerned should we be about the government debts we are leaving for our grandchildren?**