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**TRUTH AND CONSEQUENCES: A Guide to Understanding the
U.S. Government Debt and Deficits**

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The ideas presented in this research are the authors' and do not represent official positions
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Truth in Accounting Working Paper: Overview on Debt and Deficits

Truth and Consequences: A Guide to Understanding U.S. Government Debt and Deficits

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Executive Summary

There is broad consensus among citizens, elected representatives, and federal administrators that the United States government is on a fiscally unsustainable path. Since 2000 federal outlays have exceeded federal revenues in each fiscal year creating deficits, and deficits are projected for the foreseeable future. Our national debt is currently about 60 percent of the value of all goods and services produced in the U.S. economy and could reach an amount in excess of 100 percent of Gross Domestic Product (GDP) by 2020. Tackling debt and deficits is a national security issue that affects our ability to compete in the international system. The proportion of U.S. government debt held by foreign entities has significantly increased. However, contrary to conventional wisdom, foreign debt holdings are more diversified than they have been in the past: 54 percent of foreign-held debt is held by investors located in a wide range of countries. Debt and deficits are also a strategic challenge in our domestic political economy: mandatory spending on transfer payments to individuals is increasingly crowding out discretionary spending on inherently governmental functions. While increasing global competition and an aging population will make it more difficult to improve the U.S. government's fiscal position, it can be corrected and it does not depend on political affiliation or the structure of government. Democrats, Independents, and Republicans have all demonstrated that they can create deficits and debt and reduce them, and they have done so with unified and divided government. We are all part of the problem and we must all be part of the solution, which will require that we commit ourselves to engaging in reasoned problem solving based on hard facts rather than scoring points in an increasingly self-destructive game of fiscal fantasy.

“... the federal government is on an unsustainable long-term fiscal path ...”

Gene L. Dodaro, Acting Comptroller General of the United States¹

“While job creation and economic recovery remains the priority, the Government cannot borrow without limit. Once we have strong growth in place, we must begin the process of bringing down our deficits to sustainable levels. Failure to put the U.S. Government budget on a sustainable path would weaken the recovery ...”

Timothy F. Geithner, Secretary of the Treasury²

“Unless policy makers restrain the growth of spending, increase revenues significantly as a share of GDP, or adopt some combination of those two approaches, growing budget deficits will cause debt to rise to unsupportable levels.”

Congressional Budget Office³

In a town where disagreement is to be expected, one would be hard pressed to find anyone who believes that the United States government is on a sustainable long-term fiscal path.⁴ Over the past 60 years annual outlays have exceeded revenues in all but 12 fiscal years. Deficit spending along with changes in the value of federal assets and liabilities have created a level of debt that is currently estimated at more than 60 percent of the value of all goods and services produced in the United States each year.⁵ The Government Accountability Office (GAO)

¹ 2010. Statement of the Comptroller General of the United States, Report on the U.S. Government’s Consolidated Financial Statements. Government Accountability Office. February 26.

² 2010. A Message from the Secretary of the Treasury, 2009 Financial Report of the U.S. Government. U.S. Department of the Treasury. February.

³ 2010. Congressional Budget Office. “Federal Debt and the Risk of a Fiscal Crisis.” Economic and budget Issue Brief. July 27. Prepared by Jonathan Huntley.

⁴ For example, see *Taking Back our Fiscal Future* (April 2008), authored by members of the Brookings-Heritage Fiscal Seminar who are longtime federal budget and policy experts from across the ideological spectrum. Available online at: http://www.brookings.edu/papers/2008/04_fiscal_future.aspx or <http://www.heritage.org/research/reports/2008/03/taking-back-our-fiscal-future>.

⁵ Source of data for years without deficit: Authors’ compilation based on data reported in the Budget of the United States Government 2011, OMB Historical Tables, Table 1.2, Total Surplus (Deficit), 1944-2009. Source of data for debt as a percentage of GDP in 2010: Congressional Budget Office, “The Long-Term Budget Outlook. June. 2010. Unless otherwise noted, debt refers to debt held by the public, which is the accumulated amount that the government has borrowed in financial markets by issuing Treasury securities.

estimates that absent significant policy change, debt could accumulate to a historically new level in excess of 237 percent of Gross Domestic Product (GDP) by 2035.⁶

While consensus on anything other than the existence of a fiscal problem is difficult, in our view, it is nevertheless possible to dispense with the unproductive dialogue that characterizes contemporary debates and make progress in correcting our fiscal path: the key is informed citizens, lawmakers, government officials, and analysts who reason with each other based on hard data, understand and appreciate the complex interdependencies that characterize the U.S. political economy, and negotiate bargains based on a common commitment to sustaining a strong and prosperous nation.

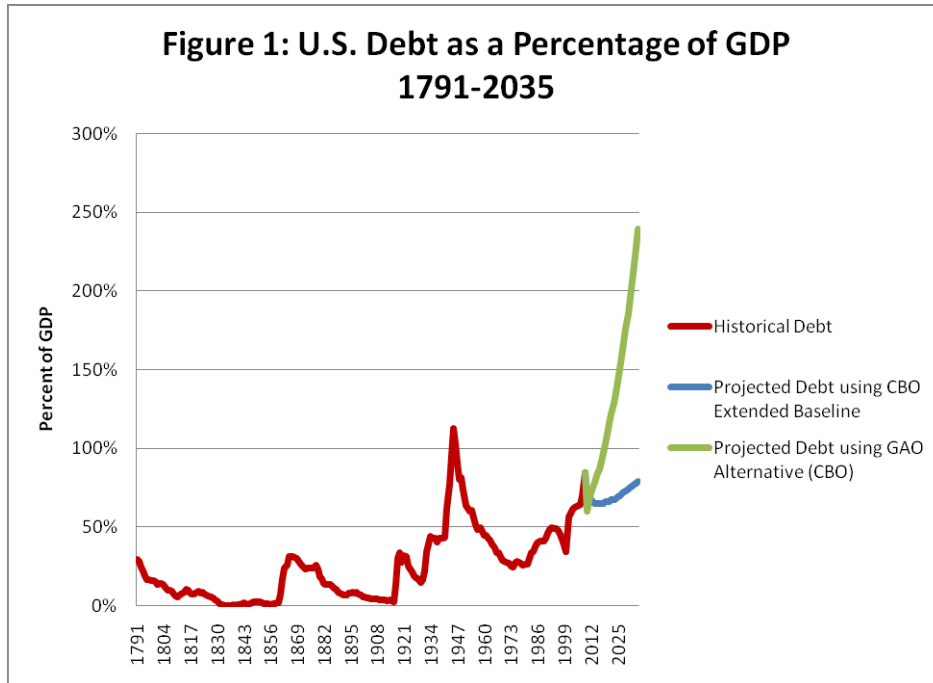
Deficits—amounts of money that the federal government spends in any given year that exceed revenues in that same year—accumulate as debt. In the 2009 fiscal year, the U. S. government budget deficit was \$1.4 trillion.⁷ When the federal government spends more than it takes in as revenues, it must borrow from the public to finance the deficit. Amounts borrowed are debt, which is a promise to pay at a future date. At the end of the 2009 fiscal year, U.S. government debt to the public totaled \$7.6 trillion.⁸

Figure 1 shows U.S. debt as percentage of GDP from 1791–2035. These data show that in the first 160 years of our republic until about 1936, we contained our debt level in a range that did not exceed 40 percent of GDP. The stops came off in 1936 as the nation grappled with the exigencies of the Great Depression and World War II: by 1944 we had accumulated debt totaling 107 percent of GDP. We steadily reduced our debt so that by 1963 it was below 40 percent for the first time in a generation. Beginning in 1980, debt levels rapidly shifted upward. By 1986, federal debt levels exceeded 40 percent. If we do not make fiscal adjustments, current estimates suggest that our debt levels may exceed 100 percent of GDP by 2020.

⁶ 2010. Congressional Budget Office. “The Long-Term Budget Outlook.” June.

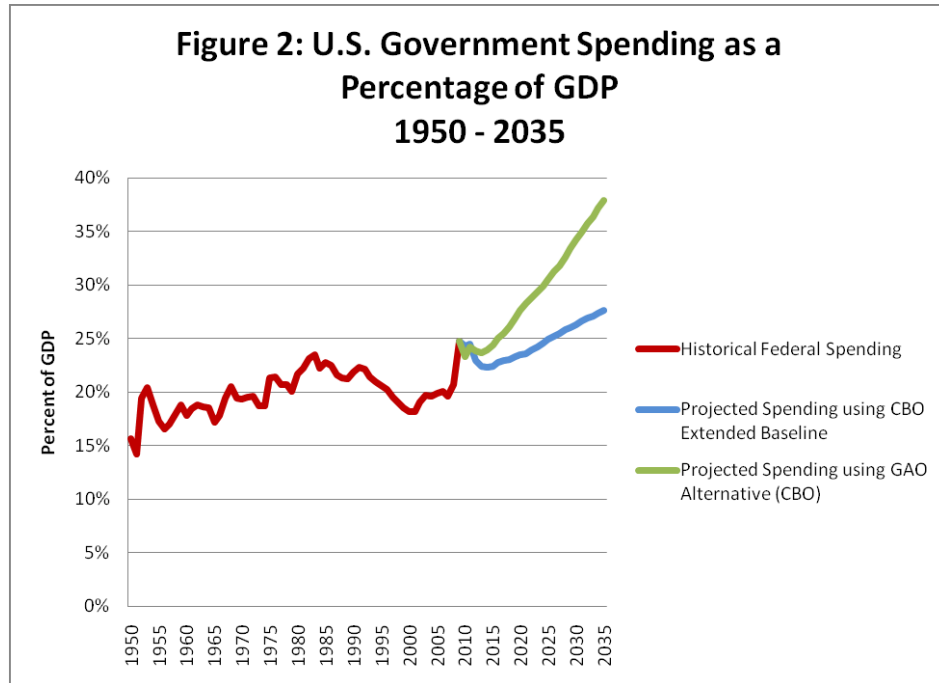
⁷ Reported on the Reconciliations of Net Operating Cost and the Unified Budget Deficit in the Financial Statements of the U.S. Government for the year ended September 30, 2009. The amount reported is the unified budget deficit.

⁸ Ibid. U.S. Government debt of \$7.6 trillion is reported on the balance sheet as a liability. It is all debt held by the public, which is the amount the government borrows in financial markets by issuing short and long-term debt securities.



Sources: GAO Data from Long Term Federal Model, <http://www.gao.gov/special.pubs/longterm/data/>
 CBO Long Term Budget Outlook, <http://www.cbo.gov/doc.cfm?index=11579>
 CBO Historical Data on Federal Debt, <http://www.cbo.gov/doc.cfm?index=11579>

To see how we have and will continue to accumulate historically high levels of debt, let's take a look at trends in U.S. government spending as well as future estimates. Figure 2 shows federal spending as a percentage of GDP from 1950–2035. Federal spending as a percentage of GDP has been increasing since 1950. However, until about 1980, we managed spending at a level that rarely exceeded 20 percent of GDP. Since 1980, apart from the period 1996–2007, the total value of federal consumption has consistently exceeded 20 percent of GDP and GAO estimates suggest that by 2035, it could be as high as 40 percent of GDP.



Sources: GAO Data from Long Term Federal Model, <http://www.gao.gov/special.pubs/longterm/data/>
 CBO Long Term Budget Outlook, <http://www.cbo.gov/doc.cfm?index=11579>
 OMB Historical Tables, <http://www.whitehouse.gov/omb/budget/Historicals/>

The data tells us that we are consistently spending at a higher rate of national income and we are accumulating higher levels of debt than at any time in the history of our country. Estimates of future spending suggest that these trends will not only continue, they will significantly accelerate.

We believe that Americans can reverse current trends in debt and deficits as they have in the past but the path is treacherous and there are many tough issues over which reasonable people can, do, and will disagree. This paper has been written to provide a guide for policy makers and observers in the long budget negotiations that lay ahead. Our aim is to demystify the U.S. government's financial position and provide resources for further investigation, analysis, and discussion. Our hope is that all those who engage in this debate will employ reason and their better angels to help them govern the process.

What is the current financial position of the U.S. government?

As you might expect, our collective self-interest is wrecking havoc on the federal balance sheet, leaving little margin for error in the event catastrophe strikes. The balance sheet shows us

where we stand as a nation today—how much we own (assets), how much we owe (liabilities), and our net worth (net position). As of the end of fiscal year 2009, the U.S. balance sheet shows assets of \$2.7 trillion, liabilities of \$14.1 trillion, and because the nation owes more than it owns the federal balance sheet shows a negative \$11.5 trillion net position (net worth).⁹ In other papers we will describe how these numbers were determined. For now, we will focus on the big picture.

Table 1 provides a summary of the change in the U.S. government's financial position over the past decade. Total assets increased from about \$911.5 billion in 2000 to \$2.7 trillion in 2009. While this represents a positive improvement in what the nation owns, the composition of the assets held has changed quite dramatically. Tangible assets (property, plant and equipment, and inventories and related property) continue to be the largest single category of reported assets, accounting for about \$1.1 trillion, or 40 percent of total federal assets.¹⁰ However, tangible assets have declined in percentage terms from 2000 when they accounted for 53 percent of total assets.

In response to concerns about the stability of the financial system and the economy as a whole, the federal government enacted legislation in 2008 to support government-sponsored entities such as Freddie Mac and Fannie Mae and invested in private companies such as AIG and General Motors. The nation's investments in these items, which show in the balance sheet as mortgage backed securities, Troubled Asset Relief Program (TARP) loans and equity investments, and the beneficial interest in trust, amounted to \$447.6 billion or 17 percent of total federal assets. Whether or not one believes that these investments were the proper course of action, by definition, investments in troubled firms expose the government to more risk due to concerns about future profitability and repayment.

⁹ See Appendix A for the 2009 U.S. consolidated financial statements.

¹⁰ For 2009, approximately 83 percent of the reported \$284.6 billion inventories and related property is in the Department of Defense (DOD). Inventories and related property include a diverse set of assets including stockpile materials consisting of crude oil held in the Strategic Petroleum Reserve (SPR) and the Northeast Home Heating Oil Reserve, nuclear materials, highly enriched uranium held by the Department of Energy (DOE) and seized and forfeited property held by the Department of Justice (DOJ), Department of Treasury, and Department of Homeland Security (DHS) (2009 U.S. Consolidated Financial Statements – Note 7 and related agency reports). For 2009, approximately 71 percent of the reported \$784.1 billion property, plant, and equipment category is in the DOD and 89 percent is located in the DOD, DOE, the Tennessee Valley Authority (TVA), the United States Postal Service (USPS), General Services Administration (GSA), Department of Interior (DOI), and Department of Homeland Security (DHS) (2009 U.S. Consolidated Financial Statements - Note 8). Also, stewardship lands and heritage assets, which include national parks, unrecovered oil and gas resources, minerals, and other natural resources, are not included as assets on the balance sheet.

For 2009 the total liabilities of the U.S. government were more than five times larger than total reported assets.¹¹ The largest categories of liabilities were federal debt securities held by the public and accrued interest on that debt (\$7.6 trillion), which was nearly three times total assets, and federal employee and veteran benefits payable (\$5.3 trillion), which was approximately twice as large as total assets. While it is tempting to take comfort that these are lower multiples of total assets than in 2000 when liabilities were 7.5 times larger than assets, this is a faulty comparison.

The scale of the nation's investment in government-sponsored entities and private firms represents a new and substantial percentage of the nation's total assets. We remove these investments from total assets to get a better idea of what our liabilities would look like without these assets (see Table 1, 2009 Restated). When we compare year-to-year without the new investments in the financial assets of troubled firms, total liabilities are more than six times assets. Federal debt securities and federal benefits rise to more than three times assets and more than two times assets, respectively: We currently have a negative net position (the difference between what we own (assets) and owe (liabilities)) of more than \$11 trillion. Moreover our total liabilities in 2009 do not take into account additional contingent liabilities,¹² nor do we currently include estimates for emergencies that we might face in the future (e.g., wars or natural disasters).

In sum, the 2009 balance sheet suggests that the United States is in a fairly risky financial position.

¹¹ Nearly all of federal debt securities are issued by the U.S. Treasury although there are small amounts issued by government agencies e.g., Tennessee Valley Authority. The federal debt securities issued by the U.S. Treasury and held by the public are either interest-bearing marketable securities (bills, notes, bonds, and inflation-protected securities) or interest-bearing nonmarketable securities (foreign series, State and local government series, domestic series and savings bonds). For 2009, federal debt securities issued by the U.S. Treasury accounted for 99.1% of the \$7.6 trillion total. For additional information, see Note 14 Federal Debt Securities Held by the Public and Accrued Interest, in the 2009 Financial Report of the U.S. Government.

¹²Contingent liabilities are estimates of amounts due in cases where there is a reasonable possibility that a loss may have been incurred. Loss contingencies for the U.S government include potential losses for federal deposit insurance, insurance contingencies for the Pension Benefit Guarantee Corporation, legal and environmental contingencies, For more information, see Note 22 in the 2009 Financial Report of the U.S. Government.

Table 1: Consolidated Financial Reports and Comparative Analysis 2000-2009

	2009	2008	2000	2009	2008	2000	2009	2009
				Stated as a percent of total asset			Restated	Percent
Total assets	\$2,667.9	\$1,974.7	911.5	100.0%	100.0%	100.0%	\$2,220.3	100.0%
Mortgage backed securities	184.4	3.4	-	6.9%	0.2%	0.0%		
TARP direct loans and equity investments, net	239.7	-	-	9.0%	0.0%	0.0%		
Beneficial interest in trust	23.5	-	-	0.9%	0.0%	0.0%		
Investments	447.6	3.4	-	17%	0%	0%		
Inventories and related property, net	284.6	289.6	185.2	10.7%	14.7%	20.3%	284.6	12.8%
Property, plant, and equipment, net	784.1	737.7	298.5	29.4%	37.4%	32.7%	784.1	35.3%
Tangible assets	1,068.7	1,027.3	483.7	40.1%	52.0%	53.1%	1,068.7	48.1%
Total liabilities	14,123.80	12,178.20	6,848.6	529.4%	616.7%	751.4%	14,123.80	636.1%
Federal debt securities held by the public and accrued interest	7,582.70	5,836.20	3,408.5	284.2%	295.5%	373.9%	7,582.70	341.5%
Federal employee and veteran benefits payable	5,283.70	5,318.90	2,757.8	198.0%	269.4%	302.6%	5,283.70	238.0%
Total net position	-11,455.90	-10,203.50	(5,937.1)				-11,903.5	
Total liabilities and net position	2,667.90	1,974.70	911.5				\$2,220.3	

Source: US Consolidated Financial Reports, selected items for selected years, available at www.gao.gov, percent calculations by authors

Mortgage backed securities from note 4 to the 2009 financial statements p. 65.

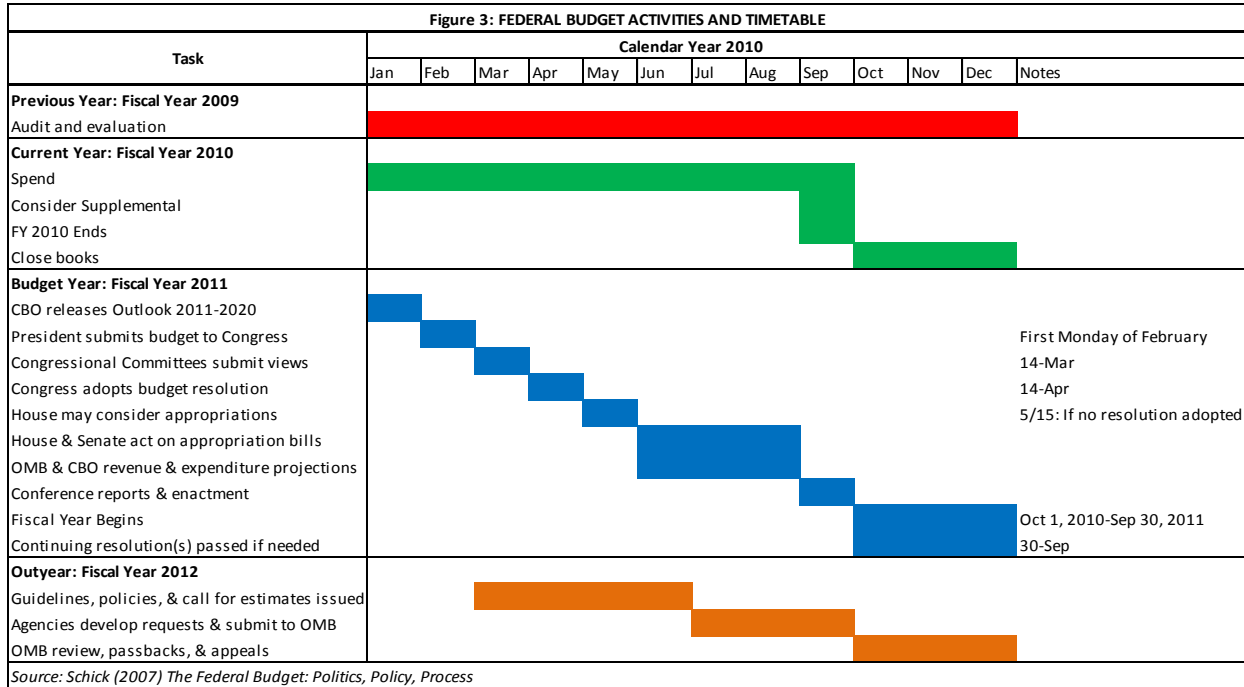
Restated 2009 amounts remove investments \$447.6 from total assets.

What is the scope of the challenge?

While it is tempting to do so, it is a mistake to compare federal government financial management to household or even corporate financial management. As one might expect in an enterprise as large and complex as the U.S. federal government, this is neither easy nor straightforward: the federal financial management process is governed by a large number of laws and standard operating procedures, extends over a 4-year cycle, and involves more than 100 operating units including the Office of the President and the U.S. Congress, multiple accounting systems, and hundreds of accounts and funds.

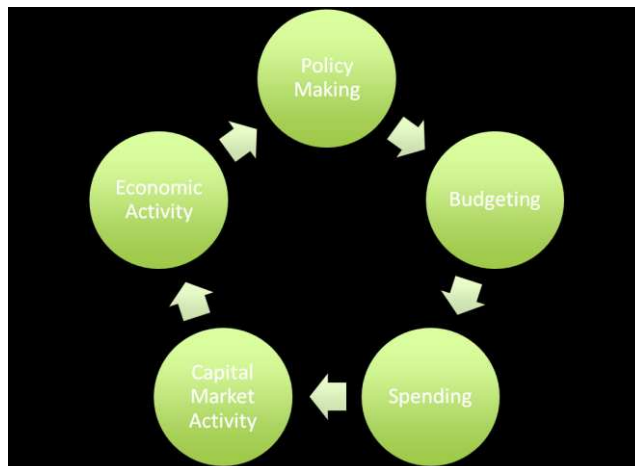
Figure 3 shows the major milestones associated with managing the federal government's financial activities, which include auditing and evaluating the financial statements prepared by operating units for the previous fiscal year, and concurrently organizing and managing the processes associated with three budget years: the current year, the upcoming fiscal year, and the out-year. The GAO is responsible for audit and evaluation activities, the Department of the Treasury takes the lead in producing the annual financial report of the U.S. Government, and the OMB takes the lead in organizing and managing budget activities. Congress has a separate

budgeting process, however unlike the executive branch, it is not required by law to produce an annual budget.



Federal financial management is not only technically complicated, it is a very complex system of strategic political and economic behavior in five arenas that are themselves quite complex: Budgeting; spending, trading in capital markets, investing and trading in the economy, and policy making.

Figure 4: Federal Financial Management System



Budgeting

The budget process, by its nature, is a complex process that requires forecasting estimates of future cash receipts and expenses. In the federal setting, budget estimates emerge from an extensive inter-governmental planning and negotiation process that involves anticipating the investment, production, and consumption behavior of millions of individuals and other entities in the United States and abroad. For example, budgeting for Social Security Insurance and Medicare programs requires assessments of demographic and economic trends, tax payments, and claims.

The over-arching goal of accounting is to provide information that is useful for decision-making purposes in planning for the future and evaluating actions taken. Budgets are one type of accounting report compiled by the federal government. Like all accounting reports, budgets are developed for a particular entity, over a specified time horizon, and using a specific set of accounting rules.

In the federal setting, budgets, which are primarily cash-based rather than accrual-based, are produced by the different agencies within the federal government. The agency budgets are then combined to produce the consolidated federal budget. In general, the cash basis of accounting records revenue (e.g., from taxes) when received in cash and expenses when paid in cash. The primary budget horizon is the fiscal year, which runs from October 1 to September 30 of the following year. Thus, the fiscal year 2011 budget year begins on October 1, 2010 and ends on September 30, 2011. In addition, however, the federal budget also includes estimates by

year for a 10-year budget window. Budgeting for a future period requires forecasts of all potential sources of revenue such as tax receipts and estimating the collection of these amounts over the planning period. Similarly, one must collect and categorize data on all potential cash expenses and determine when and how these obligations will be met. When budgeted cash receipts are more (less) than cash expenses there will be a budget surplus (deficit). Budget deficits must be funded by additional federal borrowing, which adds to the overall federal debt.

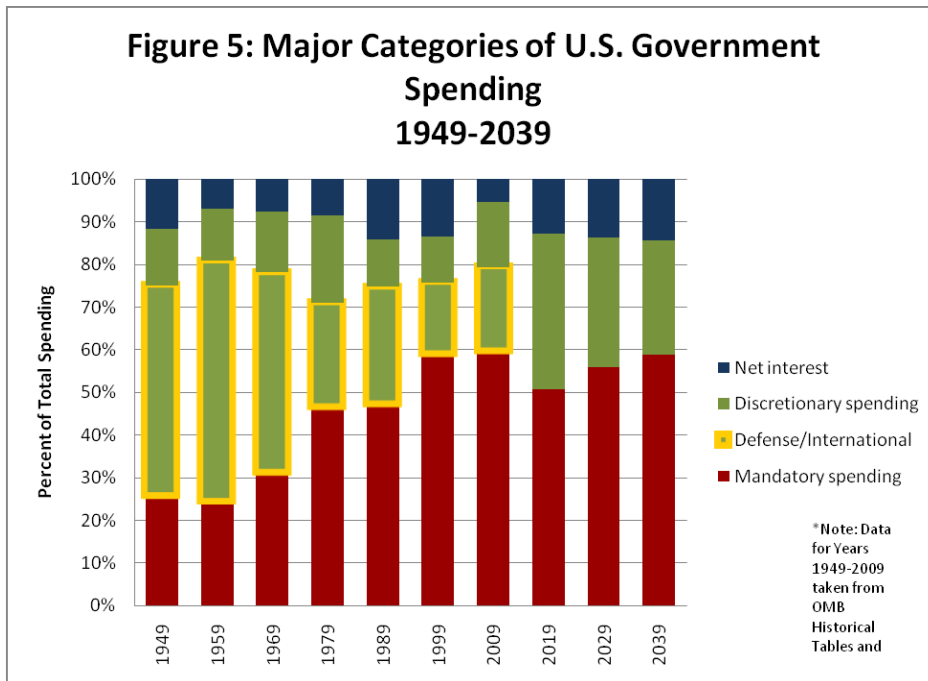
Budget estimates of the U.S. government for the fiscal year that just ended (October 1, 2009–September 30, 2010) include receipts of approximately of \$2.3 trillion, new borrowing in the amount of \$1.5 trillion, and total debt in the amount of \$9.6 trillion: Our budget, which is equal to about 7 percent of world GDP, is larger than the GDP of many countries in the world.¹³

Spending

Under federal law spending decisions are controlled and administered by two types of authority: discretionary spending authority, which is appropriated by Congress and administered by operating units in the federal government, and mandatory spending authority, which is automatically authorized by laws passed by Congress and administered by special purpose units such as trust funds.

Figure 5 shows change in the major categories of U.S. government spending from 1949 to 2039. In 1949, about 63 percent of spending was discretionary and most of this spending was attributable to defense and international assistance; about 26 percent was for mandatory spending on payments for individuals in various forms of social insurance; and the remaining 11 percent was attributable to interest payments on debt. By contrast, at the end of fiscal year 2009 as a consequence of policy and demographic changes, federal spending patterns had reversed: about 60 percent of spending was on mandatory payments to individuals, including federal employee retirement and veterans benefits; about 35 percent was discretionary; and the remaining 5 percent was interest payments on debt.

¹³ The source of fiscal year 2010 budget data is Office of Management and Budget. 2009. "Mid-Session Fiscal Review 2010." U.S. Government Printing Office. August 29. Budget documents are available electronically at www.budget.gov.



Sources: CBO Long Term Budget Outlook, <http://www.cbo.gov/doc.cfm?index=11579>
 CBO 10-Year Forecast, <http://www.cbo.gov/budget/budget.cfm>
 OMB Historical Tables, <http://www.whitehouse.gov/omb/budget/Historicals/>

Estimated U.S. government outlays for fiscal year 2010 are \$3.8 trillion.¹⁴ About 57 percent of the budget is mandatory payments to individuals under a wide range of social insurance, pension, and veterans benefits programs. The remaining 43 percent of the budget is discretionary spending: 19 percent is for defense and international assistance; 18.5 percent is other discretionary federal spending including transfers to local governments; a little over 5 percent is for interest payments on debt; and about 0.2 percent is allowance for disaster costs.¹⁵

Estimates suggest that as time goes on, mandatory payments to individuals and interest payments on debt will continue to crowd out discretionary spending. In other words, we are asking the federal government to borrow money to transfer payments to ourselves. We, not “them” are the problem.

Capital Market Activity

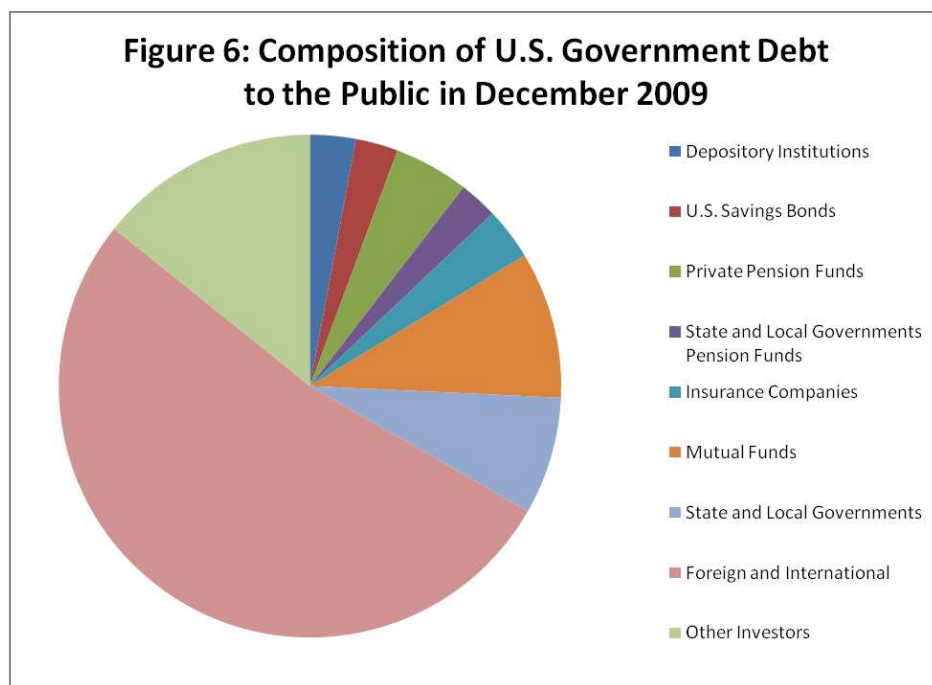
Capital markets are important in managing U.S. government finances: this is where we raise money to fund public spending and investment, and changes in the quality or volume of

¹⁴ Ibid.

¹⁵ Ibid: Figure page 5.

U.S. government securities can have wide-ranging and real effects on the overall health of the domestic and global financial systems.¹⁶

Looking at figure 6, we can see that at the end of 2009 U.S. government securities were held by a broad range of investors including individuals, pension funds, banks, insurance companies, mutual funds, state and local governments, and foreign entities: Our largest investors accounting for 74 percent of all debt holdings are foreign and international holders (52 percent), private U.S. pension funds (14 percent), and U.S. state and local governments (8 percent).¹⁷

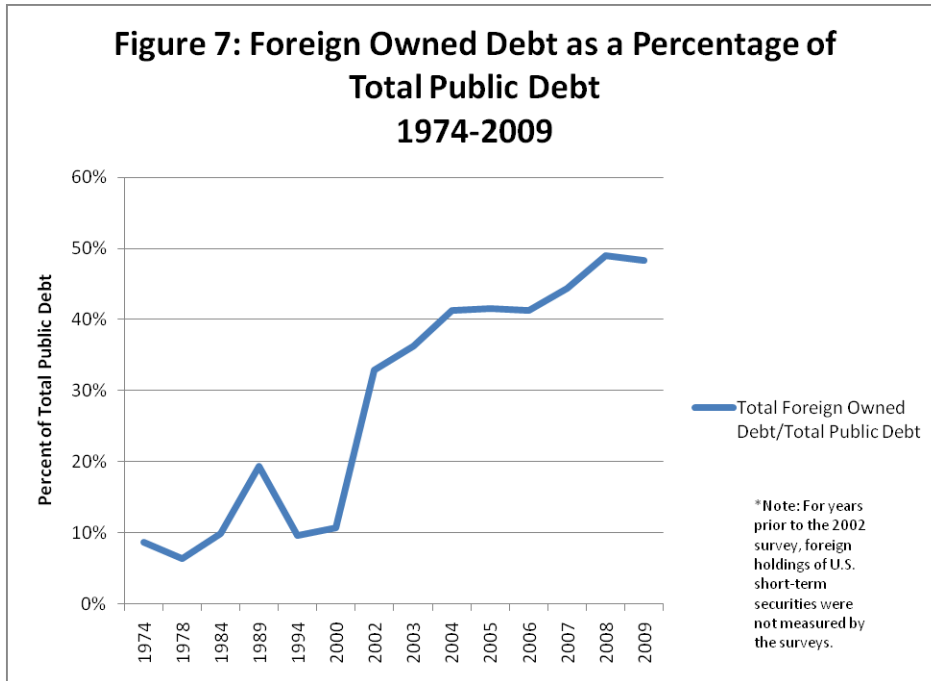


Source: U.S. Department of the Treasury, http://www.fms.treas.gov/bulletin/b2010_2.pdf

Foreign investment in U.S. government debt has increased and become more diversified over time. Looking at figure 7 we can see that until 2000, foreign-owned debt ranged from less than 10 percent of total public debt to about 20 percent. Since 2000, foreign debt ownership has dramatically and steadily increased to 52 percent in 2009.

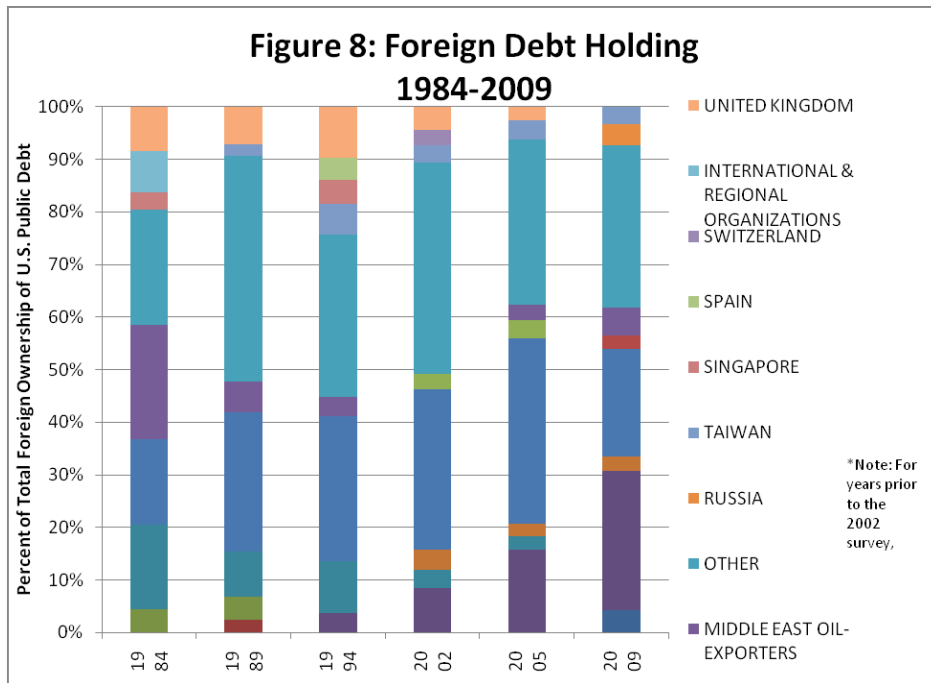
¹⁶ For an overview of the U.S. financial system and systemic risk issues, see Polski (2009).

¹⁷ Foreign and international debt holders include sovereign, institutional, and individual investors including the treasuries of foreign countries; banks, pension, and other investment funds organized in foreign countries; sovereign wealth funds; citizens of other countries.



Sources: U.S. Treasury Historical Data, <http://www.ustreas.gov/tic/shlhistdat.html>
 Treasury Direct, <http://www.treasurydirect.gov/govt/reports/pd/mspd/mspd.htm>

Who are our foreign investors? In 1984, 61 percent of all foreign-held U.S. debt was attributable to investors from about 6 countries: 21 percent was held by the oil exporting countries in the Middle East, 16 percent by Japan, 16 percent by Germany, and 8 percent by the UK. At the end of 2009, foreign debt holding was less concentrated: China held 26 percent of all foreign U.S. debt holdings, Japan held 20 percent, and the remaining 54 percent was diversified across a number of different foreign owners.



Source: U.S. Treasury Historical Data, <http://www.ustreas.gov/tic/shlhistdat.html>

Economic Activity

Domestic and global economic activity enables and potentially constrains U.S. government investment and spending: in high growth periods the volume of U.S. government receipts is greater, which permits higher levels of spending, investment, and saving; in low growth periods, the volume of receipts is less, which creates pressure on spending, investment, and savings.

At the same time, U.S. government financial activity can influence economic growth and change and abrupt changes in spending can be quite disruptive. The federal government is a significant consumer in the domestic and global economy. It is also a large employer, providing salaries and wages for about 3 percent of the U.S. workforce.¹⁸ Mandatory payments to individuals and other “automatic stabilizers” dampen fluctuations in real GDP and thus stabilize the economy in recessions by supporting private spending, investment, and savings. And by investing in public goods such as basic research (specifically, for research that the private sector

¹⁸ Authors’ estimate. Data sources: Total U.S. employment in 2008, 145.4 million (Statistical Abstract of the United States, Table 607); total federal government employment in all civilian functions, 2.8 million (US Census: Federal Government Civilian Employment by Function, December 2008); total military employment, 1.4 million (Department of Defense Active Duty Military Personnel December 31, 2008: <http://siadapp.dmdc.osd.mil>).

does not have incentives to undertake) and infrastructure, the U.S. government can create incentives for private investment in areas that involve high risk but shift the country's production possibilities frontier, improve competitiveness, and create future economic growth.¹⁹

Policymaking

The last but by no means least important arena in federal financial management is policy making. Policy makers include the usual suspects—our elected officials, executives, and program managers in Congress and the executive branch. There are also some not so usual suspects including local government policy makers and citizens who not only elect those who make public policy but influence the vast majority of federal spending and contingent liabilities with our private spending decisions.

Local government policy makers affect federal financial management by enacting policies that off-load spending or risk to the federal government. Examples include failing to fund or underfunding local social insurance such as Medicaid, or catastrophic risk funds such as public property casualty insurance funds that backstop or replace private insurance; or failing to regulate or enforce regulations that reduce systemic risk such as building codes that reduce property casualty losses in areas prone to natural disaster, or properly examining state regulated insurance funds.

Citizens affect federal financial management when we claim benefits from publicly insured programs such as Social Security, Medicare, Medicaid, government-funded pension and other benefit plans, or unemployment compensation; elect local public officials who off-load spending or risk to the federal government rather than take fiscal decisions consistent with local conditions; successfully lobby government for benefits that have limited collective advantage; accept federal compensation to subsidize personal and business risks such income or property losses resulting from as investing in property in areas subject natural or man-made disasters such as fire, flood, earthquakes, hurricanes, industrial accidents, or terrorism; fail to pay taxes, repay federally insured debt, or prudently manage federally insured investments; or engage in activities that increase the cost of public management such as federal law enforcement, park control, regulatory compliance, and so on.

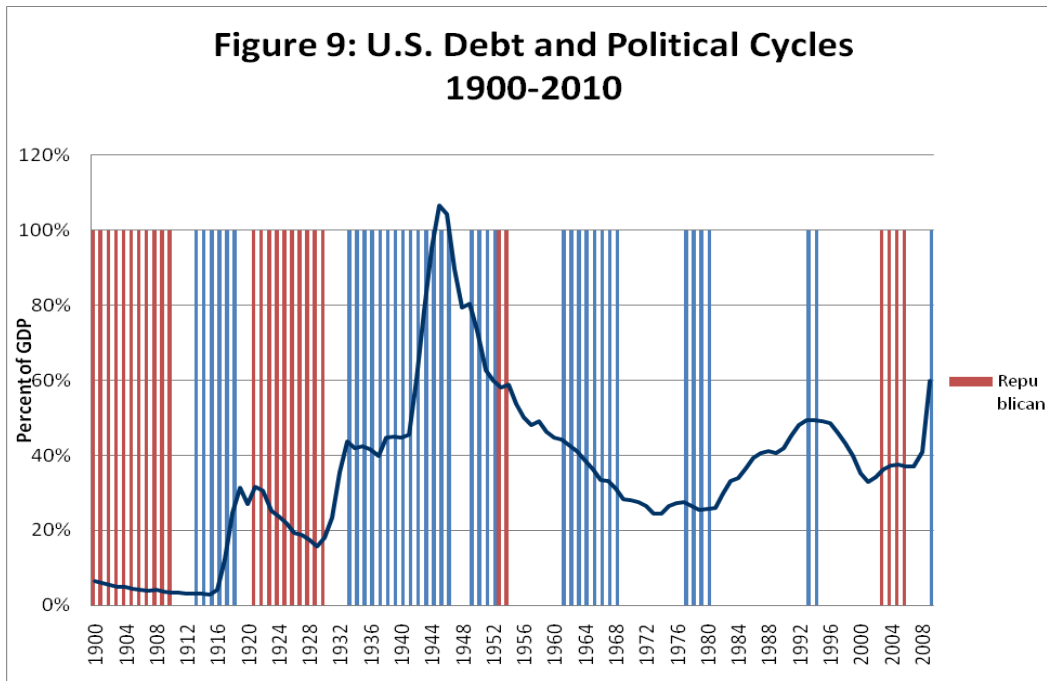
¹⁹ For an analysis of research incentives, see Polski (2006 & 2005).

What are the strategic challenges?

Contrary to conventional wisdom, U.S. debt and deficits do not appear to be associated with a particular political party or a symptom of “big government” in the classical sense of the term: the evidence suggests that they are a strategic problem that are the result of voting citizens—Democrats, Independents, and Republicans—acting in response to what they believe others will do, rather than based on a rational calculation of collective-interest or fiscal rules.

For example, if I believe that everyone else aims to get the largest possible share of public benefits, and my competitors and I elect those who referee the allocation process, than I may take less care to restrain my demands. On the other hand, if I believe that others are exercising restraint or if I suffer as a consequence of over-reaching, I may be more inclined to restrain my demands.

The data on debt and deficits underscores the strategic nature of federal financial management. Figure 9 shows change in U.S. debt as a percentage of GDP and change in political control over the period 1900–2010. The blue lines represent periods when Democrats have controlled Congress (both the Senate and the House) and the White House; the red lines represent periods when Republicans have been in charge; white space indicates periods of divided government when neither Democrats nor Republicans dominated. Looking at this array we can see that both Democrats and Republicans create debt and deficits, both reduce debt and deficits, and it doesn’t really matter if they dominate or share control of the financial management process.



Sources: OMB Budget FY 2011, <http://www.whitehouse.gov/omb/budget/fy2011/assets/budget.pdf>
 GAO Long Term Data, <http://www.gao.gov/special.pubs/longterm/data.html>
 CBO Historical Data on Federal Debt, <http://www.cbo.gov/doc.cfm?index=11579>

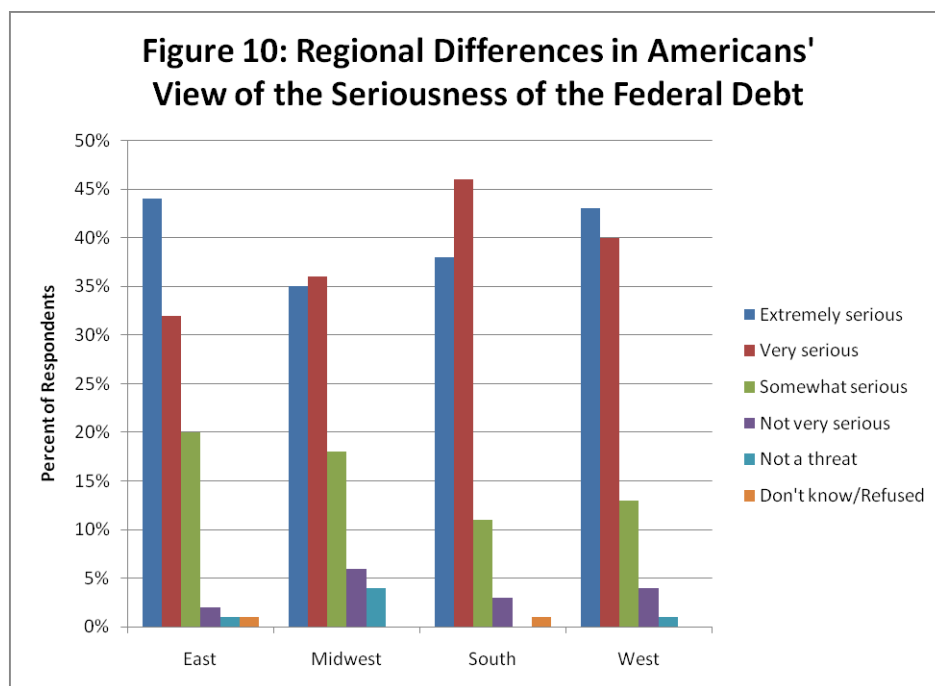
Another favorite scapegoat for explaining debt and deficits is “big government.” However, the relationship between federal government debt and deficits and “big government” is not obvious: what exactly is “big government” and how would the relative size of government affect spending and the accumulation of debt? Political economists use a wide range of measures to estimate the size of government and rather than getting larger, the federal government and its ability to control debt and deficits may actually be shrinking rather than growing compared to other periods in our nation’s history.²⁰

For example, over the period 1949–2039, discretionary spending controlled by the federal government has been increasingly crowded out by mandatory transfer payments to individuals (or our health care providers) who privately decide how they will spend the public funds authorized by laws enacted by our elected officials. Referring back to figure 5, we can see that mandatory spending has increased from 26 percent of total spending in 1949 to 60 percent in 2009 and the CBO projects that it will continue at a level in excess of 50 percent of the budget in

²⁰ Some common measures are the extent to which government rather than the private sector or private individuals control the means of production (capital, labor, technology, and innovation); the proportion of the working age population that is employed in government; the extent to which government regulates or mandates economic activity, public policy at state and local levels, and individual behavior.

future years. However, the historically high level of mandatory spending is largely due to demographic changes that increase the relative size of the population drawing retirement benefits rather than a *per se* change in the size of government.

When it comes to “somebody” doing something about debt and deficits, “them” is “us” and, as Earl and Merle Black have argued, we have quite different perspectives about public finance that it makes it difficult to govern regardless of one’s partisan allegiances.²¹ Regional differences in resources, economic structure, growth prospects, and demographics all create profoundly different technical requirements and political preferences for tax and spending policies. These differences are reflected in a recent Gallup Poll that asked Americans how serious a threat our federal debt is to future well-being: While most Americans consider the federal debt to be an extreme or very serious threat, some are more concerned than others. In the South, 84 percent consider the federal debt an extreme or very serious threat whereas significantly fewer people in the Midwest share this level of concern.



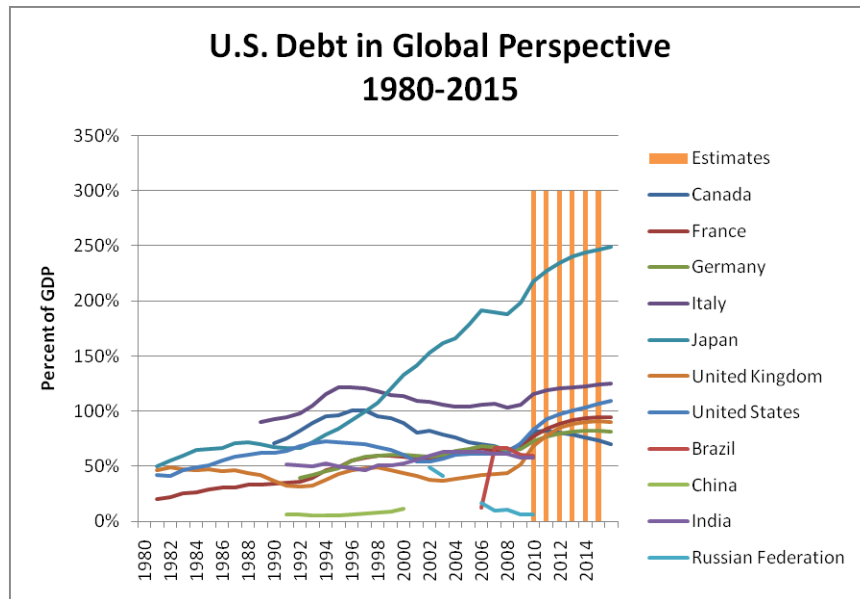
Source: Gallup, www.gallup.com

²¹ Black and Black (2008).

Yet financial strength or the ability to meet our commitments is a national security issue that threatens our standard of living and our ability to compete effectively in the global political economy. This is because when a government's financial strength is impaired, it can diminish savings and investment in the kind of activities that produce future growth, increase the cost of prudent borrowing, and limit the ability to mitigate the impact of shocks, proactively address vulnerabilities, and respond to threats.

Hence a final aspect of the strategic challenge associated with addressing debt and deficits is the widespread incidence of fiscal distress in the “developed” political economies and uneven growth in the global economy: All of the developed countries have significant debt and only modest growth prospects over the medium term while the rising political economies (Brazil, Russia, India, and China), who play the game a bit differently, appear to have stronger financial positions and increasingly aggressive political stances. Since 2000 and for the foreseeable future, the developing economies are producing more than 50 percent of global GDP and are consistently growing at faster rates than the developed countries. They account for more than 50 percent of global trade and control more than 50 percent of the cash in the global cash register. In other words, after more than 350 years of domination, the balance of power in global economic, trade, and political relations is beginning to shift away from the developed countries toward the developing economies and being burdened by debt can put us at a competitive disadvantage.²²

²² For a more extensive discussion of this change, see Polski (2008), chapter 1.



Sources: IMF, <http://www.imf.org/external/pubs/>
World Bank, <http://data.worldbank.org/country>
CIA World Fact Book Data, <https://www.cia.gov/index.html>

How can we move forward?

We have argued that current trends in debt and deficits threaten our national security and while there are many challenges associated with improving the federal government’s financial position, it can be done and it does not depend upon any particular political party or political cycle. As the data clearly show, we are all part of the problem and we must all be part of the solution. And so we end this primer with a challenge: Go to the CBO, GAO, and OMB websites, download financial data and reports, and rather than relying on “experts,” politicians, or pundits, read the reports, analyze the data, discuss the facts about our financial position with others (those with whom you are inclined to agree and even more importantly those with whom you are inclined to disagree), and then talk with members of your community and your elected representatives about what we can do together to strengthen our financial position and our ability to compete effectively in the years ahead.

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