Debt 101

How Do We Fix the Debt?

On September 8, 2017, the US debt surpassed $20 trillion for the first time. In Part 1 of the "Debt 101" series, "What is the 'National Debt' and Why Does It Matter?" the Committee for Economic Development (CED) explained what the debt is and outlined why such a large debt is detrimental. Today's young Americans will soon control the strongest, most influential economy in the world. They will also inherit an enormous debt that, if not properly addressed, could lead to an unprecedented global crisis.

Fortunately, there are solutions that can help us to achieve a stable and thriving US economy. Unfortunately, these solutions will not be painless.

What Are the Solutions to an Unsustainable Debt?

As the saying goes, if you find yourself in a hole, stop digging. Most people at least attempt to live by this rule. Governments, however, rarely do. Borrowing more money, raising spending, and cutting taxes are three surefire ways to dig deeper into the hole that is the US federal debt. And, these are three shovels that the US government continues to use.

So, what ***are*** the appropriate ways to relieve the debt burden?

Methods to return the debt to a sustainable level involve one or more of three alternatives: raising revenue, cutting spending, or growing the economy. Within these three categories are choices that are often controversial and partisan: Do we raise taxes on wealthy individuals or corporations? Do we cut military spending or social benefits? What method is most effective for growing the economy?

Raising Revenue

Raising revenue is synonymous with raising taxes. Income tax, estate tax, base erosion and anti-abuse tax, corporate tax, estate tax, gasoline tax—these are just a few of the country's many existing taxes (Figure 1). They all raise significant revenue for the US.

Increasing one or all these taxes—without harming the economy—would increase government revenue and consequently reduce the debt.

Figure 1

Collections by type of tax as a percentage of total revenue (FY 2017)

Source: Office of Management and Budget (2018)

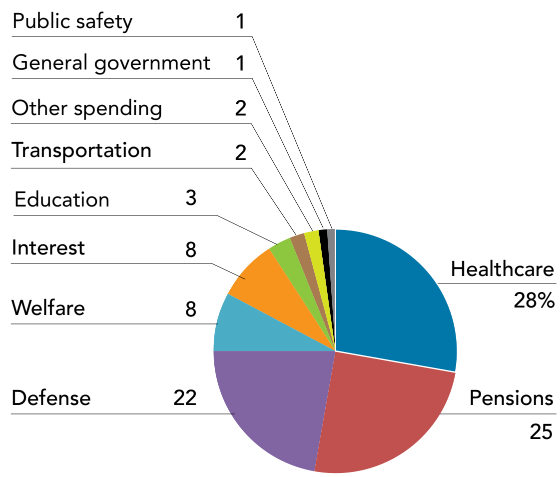
Cutting Spending

Another option to decrease the federal government's debt is to cut spending. The US government, of course, spends trillions of dollars a year—$4.407 trillion estimated for fiscal year 2019—for the protection and welfare of its citizens. This means that the federal government spends about $13,500 per citizen per year. However, in FY 2019, the government estimates that it will only receive $3.422 trillion in revenue, leaving a deficit of $985 billion for which the government must borrow money.

To reach parity, the government could cut spending to equal revenue. Spending falls into many categories, from the costliest, including Defense, Health Care, and Pensions, to the least costly: "General Government," Transportation, Public Safety (think police services, prisons, fire stations, etc.), and Education (Figure 2). Depending on your priorities, you may prefer cuts to some programs over others—our elected officials certainly do.

Figure 2

Budget projections (FY 2019)



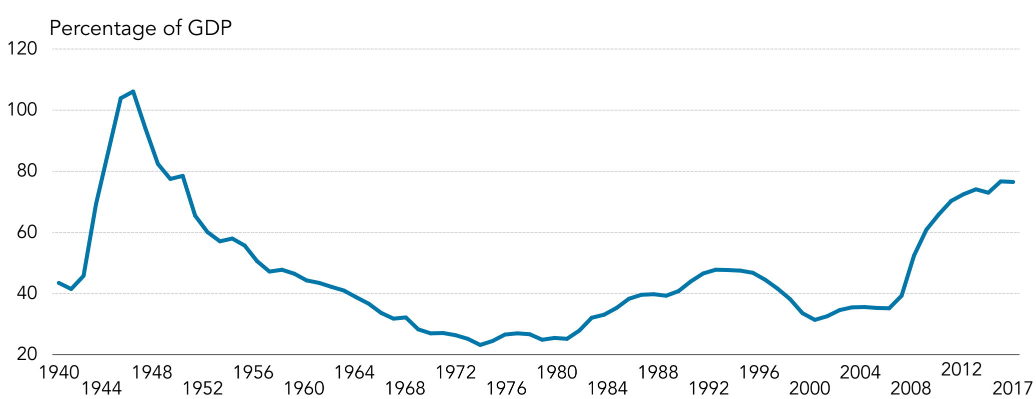
Source: Office of Management and Budget (2018)

Growing the Economy

A final way to stabilize the debt, but not necessarily decrease it in gross terms, would be to focus on the growth of the nation's gross domestic product (GDP). The debt-to-GDP ratio (usually calculated using the "debt held by the public," which omits the trust fund debt that the government owes to itself), like the size of a household's mortgage or credit card balance, is the best indicator of the burden that the debt imposes on the borrower (Figure 3).

Figure 3

US debt-to-GDP ratio, held by the public, (1940–2017)



Source: Office of Management and Budget (2018)

Investors, government leaders, and economists use this ratio as an indicator to gauge the country's ability to service and perhaps ultimately pay off its debts. A high ratio (discussed in later sections) signifies to investors that a country is not producing enough to repay those who have "bought" US debt (that is, loaned to the federal government expecting the government to repay the loan with interest).

Think of the US government as a household. Like a household, the government has an income (derived from the GDP). Banks, or in the case of the government, investors, will give the household a bigger loan if the members of the household make more money. But, if the household is not making money, the bank is unlikely to lend for fear of default.

To understand the impact of a high debt-to-GDP ratio, take the example of Greece in the mid-2010s. In 2015, Greece's debt was $352.7 billion, which seems trivial compared to its fellow EU member, Germany's $2.39 trillion. However, Germany's GDP at the time was $3.4 trillion (or a debt-to-GDP ratio of 70 percent), whereas Greece's GDP was at a low $194 billion, making its debt-to-GDP ratio a whopping 182 percent. This difference explains why Germany was in the position to bail out Greece with loans adding up to nearly $27 billion. Investors no longer felt secure buying Greek debt, correctly presuming that the country would not be able to pay interest and refinance the debt in the future.

Which Is the Right Solution?

In the end, no one solution alone is either feasible or desirable. Raising taxes alone could stifle economic growth and would certainly anger hardworking American citizens; just cutting spending would only go so far before the government failed to meet the expectations of its citizens; and only focusing on the GDP would not work, as promises of faster growth have proved empty for years (and the high debt by itself slows growth). This being true, citizens must individually choose their priorities and concoct their own perfect blend…but be prepared to compromise to achieve a sufficiently robust agreement.

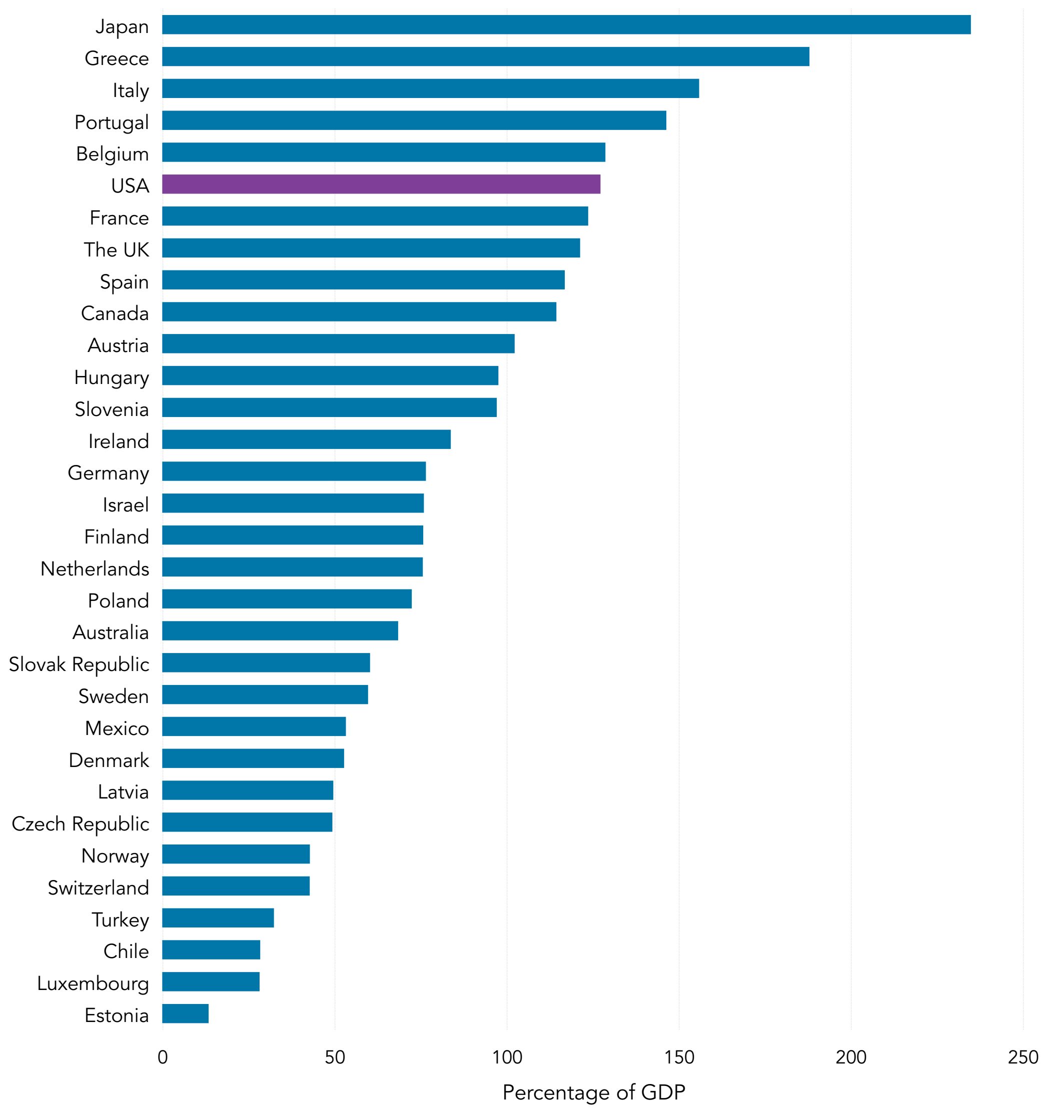
What Is a Sustainable Debt Level?

Now that we know what an unsustainable debt level looks like, we must ask, what is a sustainable debt level?

Unfortunately, there is no magic number to aim for when it comes to a healthy debt-to-GDP ratio. Some argue that the US should bring the ratio back to the pre-World War II levels of around 40 percent. Others, following the spirit and the language of the Maastricht Treaty, which established the European Monetary Union under the shared euro currency, call on the US to observe "sound fiscal policies, with debt limited to 60 percent of GDP." Of course, as Germany, Greece, and most other EU states show, that number has not been routinely achieved since the financial crisis. In fact, of the 32 OECD countries that released their debt-to-GDP values, just 12 of them have a debt-to-GDP ratio of less than 60 percent as of 2015 (Figure 4). Regardless of which number you determine to be the optimal and achievable ratio, it should, with good fiscal policies and priorities, continue at that rate or decline…it should not be rising.

Figure 4

Total government debt-to-GDP ratio, 2015
(includes national and state governments of all nations)



Source: OECD

With Today's Politics, Is There Any Hope?

In recent years, many Americans have lost their faith in Washington, with just 36 percent of Americans saying that the problem of federal debt would get better in the next few years. Which means that, if you're reading this, you are likely among the majority of citizens who do not believe that the government will do what is necessary to fix this problem. However, we at CED do believe that those in positions of power, with the encouragement of their informed constituents, can and will fix the debt.

Politicians are aware that the growing debt is a problem, but they also know that raising taxes or cutting government spending is unpopular with the American people. Therefore, if with a more complete understanding of the debt, Americans choose to reward fiscal responsibility in their government leaders, then real change is possible. Everyone has different priorities; you may prioritize military spending and want to pay for it with higher taxes. Others may want the government to cut down on social programs, allowing a simultaneous decrease in taxes. Regardless of what your own priorities may be, insist that all government actions be undertaken with an eye toward fiscal responsibility and a stable future. With an exploding debt, all our differing priorities are at risk.

Politicians and policy makers respond to the American people. When the people are informed and demand better of their government, the leaders will answer. And, if they don't, there is always someone willing to answer the call to serve. That is the power of democracy, and it is every citizen's responsibility to exercise that power.

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