The Federal Debt – Should We Worry?

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." This quote is often attributed to Mark Twain but, according to the Center for Mark Twain Studies of Elmira College, it just ain't so.

The same is true of what we think we know about the federal debt and deficit spending. For example, many people believe:

1. The government issues debt in order to finance (pay for) deficit spending.
2. Our children will have to pay off this debt, restricting future consumption.
3. We need to balance the budget.
4. The two-year budget deal just agreed between the president and Congress is an abdication of sound fiscal management.

The problem is, these beliefs just ain't so.

This column is about the federal debt, primarily the sum of all Treasury securities outstanding. It is not about municipal, corporate, student, mortgage, or any other public or personal debt, all of which require repayment and pose risks that are not applicable to federal debt. So, let's examine the above beliefs:

1. While it is commonly believed that the government either needs, or is required by law, to issue Treasury securities (debt) before it can spend, neither is true. What is true is that the Treasury's Office of Debt Management (ODM) has a policy of issuing debt after deficit spending takes place.

   So, why does the Treasury issue debt? ODM's published Overview of its debt management objectives refers specifically to the management of interest rate risk, not the financing of deficit spending. Without the debt issuance, there would be excess reserves in the banking system as a result of government spending which would drive down interest rates to unacceptably low levels, possibly zero. Issuing (selling) debt absorbs those excess reserves to maintain a targeted interest rate for interbank lending, exactly what ODM calls for. In fact, the amount of Treasury debt issuance does not correspond to deficit spending. For the period 2000-2018, fiscal deficits amounted to about $10.1 trillion while the amount of federal debt issued was about $15.8 trillion.

   Since the government doesn't borrow to spend, how does that work? The government spends from an account at the Federal Reserve. Since all credits to that account are just electronic bookkeeping entries (there's no real cash involved), it's a simple matter for the Fed to credit (increase) the account with a keystroke.

Impossible (or illegal), you say? Not so. The most visible example of this is when the Fed embarked on Quantitative Easing following the Great Recession, "keystroking" upwards of $3.5 trillion into existence to purchase various forms of government debt from the public in order to suppress interest rates and stimulate spending. Government spending by this process (some call it "money printing") has been acknowledged as the way government spending actually works by former Fed Chairs Bernanke and Greenspan.

Bottom line: the debt does not impair spending and the debt limit is actually an imposed construct to force decisions on spending despite the disconnect between the two.

2. The idea that our children will need to pay off the federal debt is not only wrong, it is an ideological claim to suppress current spending on projects and attack programs like Social Security and Medicare.

   Keep in mind that government borrowing and spending are independent activities brought together by ODM to manage interest rates. Federal debt is nothing more than domestic or foreign savings. When the debt is issued, someone's checking account gets reduced in exchange for a security (a bond) that is essentially a risk-free interest-bearing savings account.

   Unlike student debt, say, federal debt represents future consumption or investment, NOT its elimination.

3. Balancing the federal budget (or, worse, running a surplus) is, in most circumstances, wrong-headed and dangerous. In order eliminate a budget deficit, the government needs more revenue (taxes) than expenditures. This, in turn, causes the private sector to be in deficit (it's an accounting identity). If the private sector remains in deficit for long, a recession ensues. In fact, since 1970, a recession followed each time the deficit fell below about 3% of GDP.

   Unless the economy is running "too hot" (inflation above acceptable levels), balancing the budget is a bad idea.

4. The budget deal just agreed in Washington suspends the debt limit spending caps for two years while also increasing two-year defense and non-defense spending combined by about $320 billion, putting the U.S. on track to add $1.7 trillion to the deficit over the next 10 years. Is this a good idea? The answer is, it depends.

> Choices for government spending need to be examined in the context of their long-term impact on the economy and the nation's well-being. Spending that contributes to economic growth (e.g., repairing infrastructure or addressing climate change) or a social goal (e.g., Social Security or expanding healthcare access) can be both sound and desirable. Spending on defense (e.g., cyber-defense) can also be worthwhile.

Federal debt and deficit spending are very complex topics that defy our common sense understanding of the meaning of debt and prudent financial management. While people are right to be worried about government spending, they should worry about <u>how</u> money is spent (who benefits) rather than spending per se. Federal debt, a separate issue, is not like household and other familiar forms of debt and should not be thought of in the same way.

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