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RECOMMENDATION THAT PRESIDENT'S FISCAL COMMISSION FOCUS ON GROSS DEBT IS MISGUIDED

By James R. Horney

At a May 26 presentation before the President's Commission on Fiscal Responsibility and Reform, University of Maryland professor Carmen M. Reinhart asserted that the gross debt of the government of the United States — rather than debt held by the public — is what matters, and a number of commission members agreed with her. Such a focus on gross debt is seriously misguided and could inhibit the effort to address the nation's long-term fiscal challenges.

Economists Agree Debt Held by the Public Is Proper Target

The United States faces a serious long-term fiscal problem. *Current* large deficits, which are the unavoidable result of the deep recession and necessary efforts to shore up the financial system and pull the country out of the downturn, are *not* the problem. But *future* deficits are projected to spiral out of control, reaching unsustainable levels. Unless changes are made in current policies, deficits and debt will grow in coming decades to levels that most economists agree will have significant negative effects on the economy.

To deal with this problem in a sensible way, it is important to focus on the true nature of the problem and how to measure it.

Debt held by the public consists of promises to repay individuals and institutions — in the United States and abroad — who have loaned the federal government money to finance deficits. Gross debt includes, in addition to the debt held by the public, so-called intragovernmental debt —money that one part of the federal government owes another part. More precisely, intragovernmental debt consists of promises to repay certain federal government accounts, such as the Social Security Trust Funds, for amounts they lent to the Treasury in years when their earmarked revenues exceeded their outgo for benefits and other costs.

Most economists agree that the debt held by the public is what really affects the economy. As the Congressional Budget Office stated in its June 2009 report on the long-term budget outlook, "Long-term projections of federal *debt held by the public,* measured relative to the size of the economy, provide useful yardsticks for assessing the sustainability of fiscal policies." In contrast, "*gross debt . . .* is *not useful* for assessing how the Treasury's operations affect the economy."[1]

A number of organizations or individuals concerned about the effect of rising deficits and debt on the budget and the economy — the Congressional Budget Office, the Government Accountability Office, the Committee on the Fiscal Future of the United States of the National Research Council and the National Academy of Public Administration, the Peterson-Pew Commission on Budget Reform, fiscal experts Alan Auerbach and William Gale, as well as the Center on Budget and Policy Priorities — have produced detailed assessments of the long-term fiscal problem facing the United States.[2] *Every one of those studies focuses on debt held by the public.* (Every one concludes that federal debt held by the public will grow under current policies to levels that will be harmful to the economy. The decision to focus those studies on debt held by the public clearly does not arise from an effort by the authors to minimize the long-term problem the nation faces.)

Debt held by the public is important because it reflects the extent to which the government goes into private credit markets to borrow. Such borrowing draws on private national saving and international saving, and therefore competes with investment in the nongovernmental sector (for factories and equipment, research and development, housing, and so forth). Large increases in such borrowing can also push up interest rates and increase the amount of future interest payments the federal government must make to lenders outside of the United States, which reduces Americans' income. By contrast, intragovermental debt (the other component of the gross debt) has no such effects because it is simply money the federal government owes (and pays interest on) to itself.

Gross Debt Not a Reliable Indicator of Policies' Fiscal Impact

Two examples clearly show that changes in the level of gross debt do not provide a reliable indicator of the real fiscal impact of the policies that produce those changes.

Budget analysts would agree that reductions in scheduled Social Security benefits or increases in Social Security taxes would improve the federal government's long-term fiscal outlook. But such reductions would *not* reduce the projected gross debt. Debt held by the public would decline because total deficits would be lower, but the reduction in Social Security benefits or increases in Social Security taxes would also increase the surplus of Social Security income over Social Security benefit payments. That would mean that the debt holdings of the Social Security Trust Funds (intragovernmental debt) would increase by an amount equal to the reduction in borrowing from the public. *Gross debt would remain unchanged despite the clear improvement in the fiscal outlook.*

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[1] Congressional Budget Office, "The Long-Term Budget Outlook," June, 2009, Box 1-3, pp. 14-15, http://www.cbo.gov/ftpdocs/102xx/doc10297/06-25-LTBO.pdf. Emphasis added.

[2] Congressional Budget Office, "The Long-Term Budget Outlook"; Government Accountability Office, "The Federal Government's Long-Term Fiscal Outlook," January 2010; National Research Council and National Academy of Public Administration, "Choosing the Nation's Fiscal Future," 2010; The Peterson-Pew Commission on Budget Reform, "Red Ink Rising: A Call to Action to Stem the Mounting Federal Debt," December 2009; Alan J. Auerbach and William G. Gale, "Déjà vu All Over Again: On the Dismal Prospects for the Federal Budget," April 2010; and Kathy Ruffing, Kris Cox, and James Horney, "The Right Target: Stabilize the Federal Debt," Center on Budget and Policy Priorities, January 12, 2010.

Conversely, there is agreement that simple accounting changes in trust funds — for instance, transfers from the general fund to a trust fund when there are no new revenues to fund such a transfer — do *not* affect the real fiscal outlook. To take an extreme example, simply eliminating all trust funds without changing promised benefits for the associated programs would not improve the long-term fiscal outlook at all. Yet doing so would dramatically reduce gross debt. If we passed a law today doing away with all trust funds, the gross debt would suddenly fall from 89 percent of GDP to 58 percent of GDP, but we would be facing precisely the same dire long-term fiscal problem. (This example also illustrates the problem of comparing the gross debt of the United States with the gross debt of other countries that finance their social insurance programs on a pure pay-as-you go basis. Our fiscal situation is not worse than theirs just because we use a trust fund system to account for those programs and they do not.)

The long-term fiscal problem is extremely challenging. It would be a mistake to add to that challenge by adopting a misguided focus on the wrong target. It also is important that the deficit commission, which has the potential to educate policymakers and the public about our fiscal problems and the need to begin putting measures into effect to deal with it after the economy recovers, not add to confusion and misunderstanding by adopting a fiscal target that does not make sound economic sense.