

CRS Report for Congress

Received through the CRS Web

The Retirement of the National Debt: Will It Increase the Economic Size of the Federal Government?

Marc Labonte

Economist

Government and Finance Division

Gail Makinen

Specialist in Economic Policy

Government and Finance Division

Summary

Measuring the economic size of the federal government can be an elusive goal. Over the past 40 years, for example, the total outlays of the federal government have ranged between 17% and 23.5% of Gross Domestic Product (GDP). Yet, an alternative measure based on the government's consumption of goods and services, suggests a much smaller economic size: for over the past 40 years, this measure has ranged between 6% and 13% of GDP. The disparity between these two measures is accounted for by outlays that *transfer* income from some Americans to other Americans. One major transfer is interest on the national debt. The current and prospective budget surpluses suggest that the publicly held debt could be effectively retired with the coming decade. This will reduce (and eventually eliminate) future interest outlays. The government is then free to use this saved revenue for further debt reduction, other transfer payments, increased spending on goods and services, or tax cuts. If the spending option is chosen, it will increase the government's consumption of goods and services, and the share of GDP accounted for by government even though the outlays as a percentage of GDP will remain constant. A transfer payment will have been converted into an outlay that will increase the percentage of GDP consumed by the federal government. Depending on which measure of size is used, the economic size of the federal government could increase. This report will be updated as events warrant.

The Federal Government and the Economy

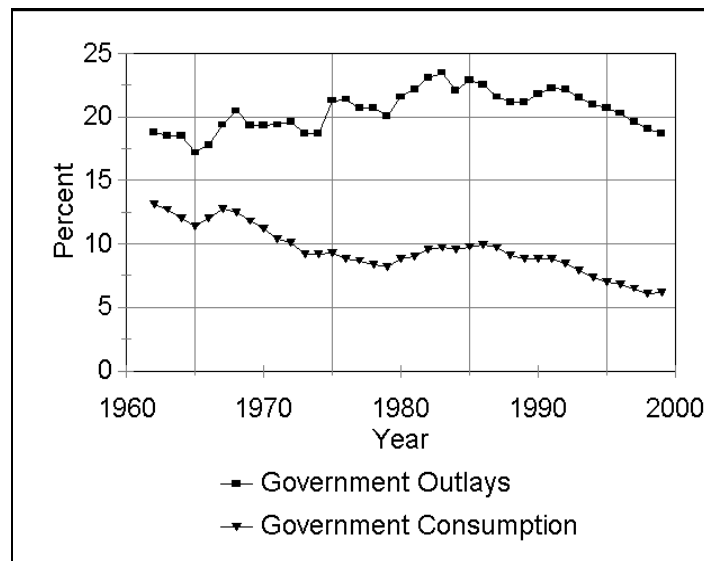
During 1999, the total outlays, or spending, of the federal government were \$1703 billion, equivalent in size to about 18% of Gross Domestic Product. Over the past 40 years these outlays, as shown in Figure 1, have varied between 17% and 23.5% of GDP. While this is one measure of the economic "size" of government, economists are often

interested in an alternative measure of “size” and it comes from the data on GDP. These data show that during 1999, the federal government’s consumption of goods and services was about \$569 billion and, that as a result, it consumed about 6% of GDP. Over the past 40 years, this federal share of GDP has varied between 6% and 13%.

These alternative measures of economic size are quite different and raise the question of whether some type of creative accounting is being used. This is most assuredly not the case. The reason for the disparity is that government outlays fall into two groups: those for the consumption of goods and services and those that *transfer* income between groups. Only the former type of outlays enters the GDP accounts. The latter do not because the resources involved are not consumed by the federal government. Despite passing through the government’s hands, they are ultimately consumed by the recipient of the transfer. These transfers include outlays for social security, unemployment compensation, interest payments on the national debt, grants to state and local governments, and the like. The amounts of outlays used for transfers are equivalent in size to between 6% and 14% of GDP over the past 40 years.

Source: National Income and Product Accounts, Bureau of Economic Analysis (Washington, DC:

Figure 1: Government Outlays and Consumption
(By Fiscal Year, As a Percentage of GDP)



July 2000); Historical Tables, Office of Management and Budget (Washington, DC: 2000).

Note: Government consumption is measured according to NIPA definitions.

Curiously, the current and prospective budget surpluses and the alternative uses for them, raise the possibility that what had been a transfer payment could be turned into an increase in the government’s consumption of goods and services. Thus, while one measure of the “size” of government could remain unchanged, the alternative measure of “size” could increase.

Budget Surpluses and Future Transfer Payments

In 1998, the federal government began to run budget surpluses as its receipts exceeded its outlays. The Congressional Budget Office (CBO) now forecasts that budget surpluses will continue through 2010, the end of its forecast period. This sequence is shown on Table 1. CBO assumes that the budget surpluses are used to retire the publicly held debt.¹ These surpluses are forecast to be large enough that by 2007 a major portion of the national debt will be effectively eliminated.² The debt will be effectively eliminated because the Treasury will be unable to retire a small portion of the debt that the public will be unwilling to sell. CBO projects that this non-redeemable sum will be quite large – between \$1081-830 billion from 2007-2010.

**Table 1: Projected Budget Surpluses and Debt
(By Fiscal Year, in Billions of Dollars)**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
On-Budget Surplus	84	102	126	143	154	169	222	260	288	332	377
Off-Budget Surplus	149	165	186	202	215	232	247	263	278	293	307
Total Surplus	232	268	312	345	369	402	469	523	565	625	685
Interest Payments	224	218	201	174	151	126	101	81	72	64	59
As a % of GDP	2.3	2.1	1.8	1.5	1.2	0.9	0.7	0.6	0.5	0.4	0.4
Publicly Held Debt	3409	3158	2854	2522	2165	1774	1315	1081	989	887	830
As a % of GDP	34.9	30.7	26.4	22.3	18.3	14.3	10.2	8.0	7.0	6.0	5.4

Source: CBO, *Budget and Economic Outlook*, (Washington, DC: June 2000)

Paying down the debt, however, has an effect on federal transfer payments since it reduces federal outlays for interest.³ And, as can be seen from Table 2, interest payments are currently a major outlay item in the federal budget. During 1999, they amounted to \$230 billion, a sum equivalent to 2.5% of GDP and about one-ninth of all government outlays. By 2007, interest payments are forecasted to be \$149 billion lower than they were in 1999. To put this amount in perspective, consider that this reduction is larger than the federal budget surplus in 1999.

¹ These CBO forecasts are based on the assumption that both the tax system and the benefit structure of entitlements remain unchanged and that discretionary spending grows at the rate of inflation. The assumption implies that no new tax or spending proposals, including those already under consideration, become law.

² Debt owed to the trust funds are ignored because they simply represent an IOU from the Treasury to the trust funds. It is debt held by the public in the form of Treasury bonds that affects the economy.

³ For a discussion of other major effects of retiring the debt, see CRS Report RL30614. *What if the National Debt Were Eliminated? Some Economic Consequences*. By Marc Labonte. July 14, 2000.

**Table 2: Composition of Federal Government Revenues and Outlays
(In FY1999)**

Budget	Billions of Dollars	As a % of GDP
Revenues	\$1827	20%
Outlays	\$1703	18.7%
Consumption	\$569	6.1%
Transfers	\$1134	12.6%
Interest	(\$230)	2.5%
Others	(\$904)	10.1%
Surplus	\$124	1.4%

Source: CBO, *Op cit.*; National Income and Product Accounts, *Op. cit.*

The federal revenue that was being used to cover the outlays for interest, will now be available for four alternative uses. It can be used to further reduce the national debt, for outlays on goods and services, for other transfer payments such as grants to state and local governments, or can be eliminated through tax reductions. CBO's projections assume that the revenue will be used for further debt reduction. However, this option is only available until 2007 when the debt is effectively retired. From that point on, unless the government is intent on accumulating private sector assets, the revenue will have to be used for additional outlays, transfer payments, or for tax cuts.

Should the revenue be eliminated through tax cuts, federal tax receipts and outlays as a percentage of GDP would fall, but the share of GDP accounted for by federal government consumption would remain unchanged. If the revenue were used for other transfer payments, then both outlays as a percentage of GDP and government consumption as a percentage of GDP would remain the same. If the revenue were used to purchase additional goods and services, the percentage of GDP accounted for by the federal government would increase, even though the percentage of GDP accounted for by total outlays would remain unchanged. And this increase could be significant. During 1999, the purchases of goods and services by the federal government accounted for a little over 6% of GDP while federal interest outlays were about 2.5% of GDP. If the revenue that is unencumbered by the reduction in interest payments were to be used for additional purchases of goods and services and if the government's share of GDP for 1999 remains intact for 2010, the data in Table 1 suggest that the federal government's share of GDP could rise to a little over 8% by 2010. This would be an increase of about one-third from 1999.

Some Second Order Effects

The use of the current and projected surpluses for alternatives such as other transfer payments, tax reduction, and for goods and services, has a number of second order effects that should not be neglected, for they can affect the rate of growth of GDP and the economic well-being of the country over the longer run. Should the surplus be used for tax reductions, depending on how they are structured, it could affect the incentives of the

private sector to work, save, and invest.⁴ If the effect on incentives is positive, the medium term rate of growth of GDP could be enhanced. Alternatively, should the government substitute expenditures on goods and services for the diminished expenditures on interest, additional resources would be drawn from private sector use. It is argued by economists that most often the private sector uses those resources more efficiently than does the government.⁵ If it does, then, from an efficiency perspective, there would be negative consequences for the economy.⁶ By contrast, since the revenue is currently being used for transfers to bondholders, like any transfer payment to individuals, the resources remain in the private sector. There is some loss of efficiency, but it is from different sources: the administrative cost of government transfers, and the fact that transfers may change incentives to work, save, and invest. For example, some economists say that the national savings rate is lower than it otherwise would be because Social Security is structured as a pay-as-you-go system.⁷

Finally, there are distributional consequences to consider. Interest payments transfer resources from taxpayers to bond holders. If the saved revenue is used for tax cuts or increased government spending, resources will be directed towards the recipients of the new tax cuts or spending rather than towards bond holders. If the saved revenue is used for further debt reduction, the revenue will continue to be directed towards bond holders. Other effects are also possible that may outweigh these considerations, based on the specific use of the saved revenue.

Summary

The current and projected budget surpluses appear to make it possible for the publicly held national debt to be effectively retired within the coming decade. Debt retirement opens the opportunity to shift the composition of federal outlays because it reduces and may eliminate a large expenditure item in the federal budget: interest on the public debt. Alternative uses of the unencumbered revenue could have significant effects on the economy and on the economic “size” of the government. If it is used to increase government purchases of goods and services, it will, all else held constant, increase the portion of GDP consumed by the federal government – one measure of the size of the government – even though federal outlays – an alternative measure of the size of the

⁴ While the idea that tax cuts affect incentives is uncontroversial, the magnitude of the effect on incentives is controversial. For an overview of these issues, see Center for the Study of American Business, *The Supply-Side Effects of Economic Policy*, (Federal Reserve Bank of St. Louis: 1981.)

⁵ One exception could be if government outlays were used for public investment (since public investment involves the purchase of capital goods, it would increase government as a percentage of GDP.) Public investment could be more efficient than if those resources were used by the private sector. But this statement depends on several caveats. First, the public investment replaces private consumption, and does not simply substitute for private investment that would have been undertaken otherwise. Second, that the public investment yields a rate of return equal or higher than the market rate of return for similar investments.

⁶ Similarly, should the federal government increase its transfers to state and local governments such that they could increase their use of resources, it could also be seen by some to negatively affect the efficiency of the economy.

⁷ Alan Stockman, *Introduction to Macroeconomics*, (Fort Worth: Dryden Press, 1999), p. 380.

government – remains unchanged. Should it be used to initiate new or expand existing transfer programs, both measures of the size of the government – federal outlays as a percentage of GDP and the percentage of GDP consumed by the government – will remain the same. Should it be used to reduce federal taxes, it would reduce federal outlays as a percentage of GDP without having any effect on the percentage of GDP used by the federal government. In this instance, one measure of the size of the government would fall while the other remained constant. In addition to these direct effects, there are other second order effects that could be important over the longer run especially since they could affect the incentives to work, save, and invest.