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Summary: *National debt is widely and falsely feared. Prudent use of debt can be a tool of national greatness. Using debt to overhaul the current tax code and transition Social Security into pre-funded private accounts would significantly enhance the nation's economic well being. The misguided consensus to "pay down the debt" will inevitably result in surpluses squandered and missed opportunities for future generations.*

Who's Afraid of the National Debt?

The Virtues of Borrowing as a Tool of National Greatness

Conventional wisdom says that prolonged government borrowing is wrong. While that philosophy may be conventional, it's not wisdom. On the contrary, modest deficits and a prudent level of government debt are nothing to fear.

Yet among many political leaders exists the false premise that reducing the dollar level of federal debt through fiscal austerity is sound financial practice—a premise disproved every day by successful private sector firms and by the nation's economic track record. Apparently each generation must rediscover what seems at the time a heretical idea: debt judiciously incurred and productively employed can benefit a nation, and that there is a difference between prudence and profligacy.

Debt and the risk-taking associated with it are the nuclear forces of economics. Financial leverage is an incredibly powerful source of economic energy. Properly harnessed, debt can fuel an entire economy to unprecedented heights of success and prosperity. Imprudently handled, it can lead to economic meltdown.

This study argues that the U.S. should stabilize the debt burden right where it is at about one-third of national income. This "neutral debt-burden" fiscal strategy would allow the federal government to borrow additional funds each year sufficient to overhaul the tax code and to convert Social Security into a payroll-tax-financed worker-investment retirement program.

Borrowing prudently to finance these two goals will produce steady and long-term growth, greater security, and a higher standard of living than could be achieved through paying off debt and accumulating a large portfolio of private assets. The long-term steady course is to hold tax rates to an absolute minimum and to maintain borrowing at safe, productive, and sustainable levels. The ensuing high-growth trajectory is our best chance for multigenerational economic health and lasting prosperity.

By contrast, rushing to pay off the debt in the short-term is myopic because it comes at the expense of other more beneficial endeavors and slows our nation's forward momentum through uncontrollable borrowing, unbearable tax increases, and unacceptable retirement benefit reductions to future generations.

Lessons from the Past

Alexander Hamilton saw value in using the nation's borrowing power to establish and maintain a rock-solid currency, which

he believed would permit the young nation to become an economic powerhouse. To Hamilton a national debt could be a national blessing. For years archrival Thomas Jefferson disagreed but later as president, Jefferson increased the national debt 12% with the Louisiana Purchase, an action universally and correctly praised. Making prudent use of the nation's borrowing power was and still is a national blessing.

Twenty years ago the U.S. used debt to achieve economic revival. In 1980 the country was mired in "stagflation"—simultaneously accelerating inflation and rising unemployment. Some economists urged wage and price controls; others wanted to raise tax rates and print more money. Ronald Reagan chose a third option. Recognizing the need to restore economic incentives, he devised a program that cut tax rates across the board, promoted sound money, and reduced excessive regulation.

President Reagan's strategy worked. Except for a short economic downturn in 1990-91 and a slow recovery during President's Clinton's first term (both brought on by tax rate increases), America has enjoyed 18 years of stable inflation and fast-paced uninterrupted economic expansion. Yet despite the success of Reagan's policy, today's political-economic paradigm that has replaced it is austerity masquerading as fiscal discipline.

Historic Roots of the Contemporary Debate

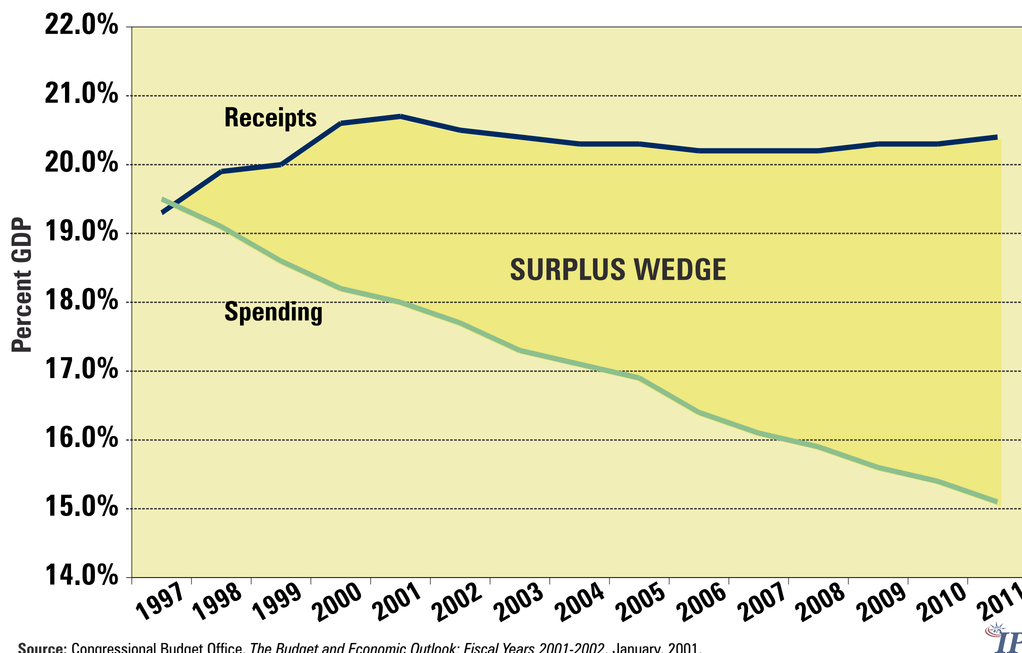
In recent times, the political opposition to deficits and the public debt has been based more on political expediency than on moral or economic principles. Post-Nixon Republicans railed against budget deficits—an argument embraced by the public—when actually the object of their ire was rising federal spending. They believed it would be more difficult for liberals to increase spending if Congress were forced to balance the books each year. As a result, many conservatives favored a balanced budget/tax limitation amendment to the Constitution.

President Reagan defied that trend, but after his sweeping tax rate reductions, his political opponents sought to frame the federal deficit and public debt as problems and then blame them on tax rate reductions. The profligacy frame was convenient because so many Republicans were apologetic about the deficits and found it impossible to overcome the debt phobia they had suffered throughout their political careers. The result of the bipartisan cabal against deficits was almost yearly tax increases between 1982-86.

The times were doubly ironic for the Republicans. They were supposed to be quintessential capitalists willing to use financial leverage prudently to enhance growth. Yet they found themselves paralyzed by debt phobia. That led to the 1990 tax hike which contributed to the recession and in turn handed the 1992 election to Bill Clinton. Yet by the end of Clinton's second term, austerity economics had so infected his administration that his oft-repeated assertion was "deficit reduction helped the economy grow."

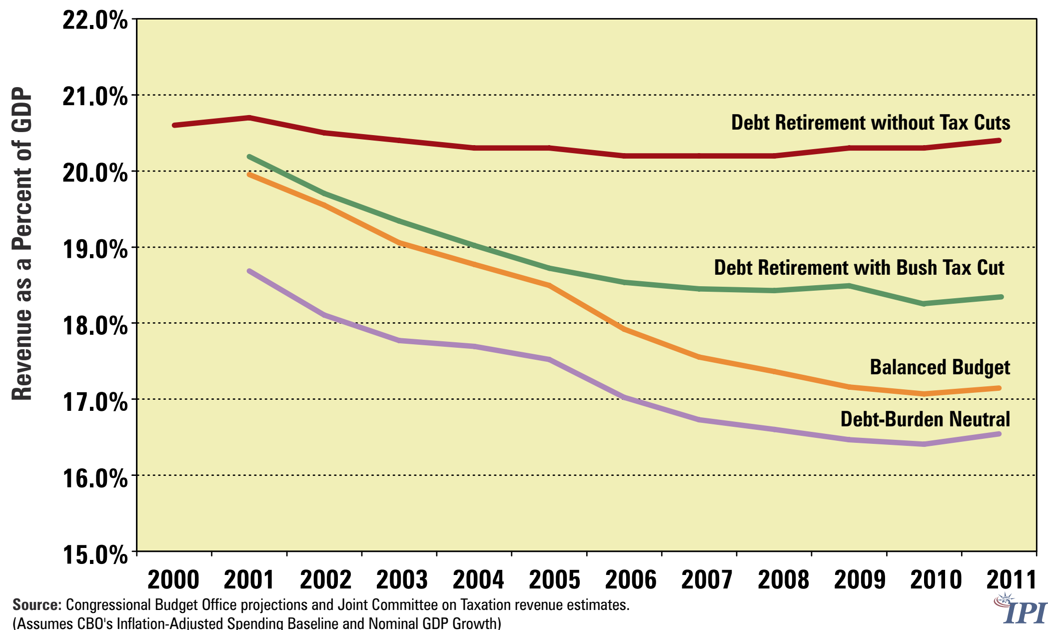
In 1997, budget deficits turned into budget surpluses as far as the political eye could see—about 15 years. Simultaneously a bipartisan "Washington Consensus" emerged that wanted to let the surpluses run to pay down the national debt. While sold as an economic plan, it was conceived as a political strategy of stalemate that uses surpluses as a wedge between tax revenue and government spending, in effect blocking tax cuts on one side and spending increases on the other. [See Figure 1]

Figure 1 **The Washington Stalemate: Tax Burden Kept High and Spending Reduced to Retire the National Debt**



Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001-2002*, January, 2001.

Figure 2 Revenue Paths Under Alternative Debt Management Policies



Source: Congressional Budget Office projections and Joint Committee on Taxation revenue estimates. (Assumes CBO's Inflation-Adjusted Spending Baseline and Nominal GDP Growth)

As a result of this stalemate and a rapidly growing economy, budget surpluses of $5.6 trillion are anticipated in the coming decade. Afraid of yielding to their opponents, both Republicans and Democrats may allow the stalemate to prevent significant additional tax rate reductions and then let the surpluses disappear into high spending increases.

The Debt Retirement Fallacy

Debt is intrinsically neither good nor bad. It is simply a financial tool, and like any other tool can be either productive or dangerous. That's why a "debt-burden-neutral" fiscal policy is safe, achievable, and vital. Prudent, controlled borrowing undertaken now to overhaul the tax code and restructure Social Security will yield a future windfall of higher revenues from a larger tax base at lower rates, which in turn will fend off unavoidable and uncontrollable borrowing when the baby boomers retire. But to achieve those goals, we need to dispel several "myths" about debt retirement

Myth #1:
Debt retirement eliminates the interest burden.

The obsession over the amount of interest due on the public debt (approximately $3,450 billion between 2000 and 2015) fails to take into account the growth-inducing private investment opportunities that would have to be taxed away ($3,639 billion) in order to retire the public debt and eliminate those interest payments.

Said another way, it is sound financial practice for the government to borrow money at 6 percent interest and then invest it for a 10 percent return. Rolling over debt is perfectly legitimate for any entity that's growing wealthier; moreover, prudent use of debt financing enhances long-term growth. Successful corporations do it all the time; so can the nation.

Myth #2:
The nation's capacity to service debt is limited.

Policymakers fret over the size of the public debt ($3.4 trillion) without considering the nation's income-producing capacity to service that debt. Over America's entire history, with only brief periods of economic contraction, the nation's output has grown steadily. Over the past 50 years, GDP has risen at an average annual rate of 3.2% after accounting for inflation. In 2000, GDP stood at $10 trillion, and with the right economic policies it can be expected to grow at least as fast if not faster indefinitely into the future.

Policymakers miss the fact that while public debt climbed by more than 50% from 1990 to 2000 the debt burden on the economy fell from 42.4% of GDP to 36.2% because the economy grew faster than the debt. If the federal budget remains in balance, if surpluses are returned to taxpayers through rate reductions, and if the economy grows at the same pace as it has since World War II (3.2% a year), then the debt burden on the economy will fall to less than 15 percent of GDP by 2015—without a single dollar of debt having been retired.

Myth #3:
Debt retirement increases savings.

In fact, contemporary experience suggests the opposite. Since 1993, during which time deficits became surpluses, those surpluses have come almost directly at the expense of lower personal savings.

Myth #4:
Deficit/debt reduction lowers interest rates.

Actually the weight of empirical evidence is that interest rates were unaffected by government budget deficits even when they hit their highest point in recent times—6.1 percent of

GDP in 1983. That would amount to about $600 billion today, or a mere 0.8 percent of the $70 trillion global capital market. Actually, since 1993, interest rates in general have risen, not fallen.

How to Escape the Austerity Trap

Because a prudent, growth-oriented policy yields better overall economic performance, it becomes vital that policymakers get out of the debt-phobia box. The choices they face for financing federal expenditures are similar to those in the private business sector:

Choice #1: Debt retirement

This is the national equivalent of "unborrowing." Businesses using this option usually have lost confidence in their future and use surpluses from current operations to liquidate past loans.

Choice #2: Balanced budget

This choice means refusing to borrow, even to take advantage of great opportunities. While this is less pessimistic than debt retirement, it is still debt-phobic when there are lucrative purposes to which new borrowing can be put. It's also a deceptive option because a modest level of economic growth can mask the missed opportunities for greater wealth creation.

Choice #3: Debt burden growth

Few if any economists would recommend that the government assume a growing debt burden. Yet this is precisely the long-term fiscal strategy implicit in the conventional wisdom of retiring debt today and forgoing important reforms so we can borrow more tomorrow to fund Social Security's day-to-day operations. Such a policy is the antithesis of fiscal discipline.

Choice #4: Debt burden neutrality

The best formula for maximizing economic growth is to identify high-yield structural reforms to government, establish a targeted range for the debt burden—the ratio of debt to GDP—and then manage the budget so the debt does not fall below the target into the stunted growth area or rise above the target onto the debt-burden growth area. [See Figure 2]

Debt-burden neutrality allows debt to grow incrementally each year to keep the debt-to-GDP ratio in bounds while investing the proceeds in growth-enhancing reforms. As long as inflation remains under control and the debt burden is small enough not to create economic distortions or dislocations, then the national debt can be permitted to grow annually in nominal terms without increasing the debt burden.

The Growth Maximizing Policy

A debt-burden-neutral fiscal policy maximizes growth because it maintains a steady debt burden that permits the federal government to make long-term investments in long-term structural reform. But to achieve its full potential, our nation must find the courage to reject debt phobia and adopt an attitude of optimism. If Congress and the president went for the growth-maximizing option and sought to maintain the nation's debt burden within a targeted safe zone, it would be possible to completely overhaul the federal tax system and fundamentally restructure Social Security as a personal investment program.

At a minimum it makes more sense to cut taxes, balance the budget, and return all surpluses to taxpayers than it does to employ the current tax code to raise the surpluses necessary to retire the public debt which comes at the expense of stifling saving, shrinking investment, and retarding economic growth.

Conclusion

Our 21st century economy is burdened by old-fashioned impediments to growth. We are financing our government with a tax code from the last century based on public finance theories that help produced the Great Depression. Then we support our senior citizens with retirement programs that came out of that same Great Depression built on demographic assumptions a generation out of date.

As an alternative, let's go for growth. If that requires a modicum of borrowing each year, let's do it. As Hamilton prophesied 200 years ago: It will be a national blessing to us.

This study is a summary of IPI Policy Report # 159, *Who's Afraid of the National Debt? The Virtues of Borrowing as a Tool of National Greatness*, by Lawrence A. Hunter, Chief Economist at Empower America, and Steve Connover.

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