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# What The National Debt Means To You

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The national debt level has been a significant subject of U.S. domestic policy controversy. Given the amount of fiscal stimulus that has been pumped into the U.S. economy over the past couple of years, it is easy to understand why many people are starting to pay close attention to this issue. Unfortunately, the manner in which the debt level is conveyed to the general public is usually very obscure. Couple this problem with the fact that many people do not understand how the national debt level affects their daily life, and you have a center piece for discussion.

**National Debt vs. Budget Deficits**

Before addressing how the national debt affects a people and a nation, it is first important to understand what the difference is between the federal government's annual budget deficit, and the country's national debt. Simply explained, the federal government generates a budget deficit whenever it spends more money than it brings in through income-generating activities such as taxes. In order to operate in this manner, the Treasury Department has to issue treasury bills, treasury notes and treasury bonds to compensate for the difference. By issuing these types of securities, the federal government can acquire the cash that it needs to provide governmental services. The national debt is simply the net accumulation of the federal government's annual budget deficits.

**A Brief History of U.S. Debt**

Debt has been a part of this country's operations since its economic founding. However, the level of national debt spiked up significantly during President Ronald Reagan's tenure, and subsequent presidents have continued this upward trend. Only briefly during the heydays of the economic markets in the late 1990s has the U.S. seen debt levels trend down in a material manner.

From a public policy standpoint, the issuance of debt is typically accepted by the public, so long as the proceeds are used to stimulate the growth of the economy in a manner that will lead to the country's long-term prosperity. However, when debt is raised simply to fund public consumption, such as proceeds used for Medicare, Social Security and Medicaid, the use of debt loses a significant amount of support. When debt is used to fund economic expansion, current and future generations stand to reap the rewards. However, debt used to fuel consumption only presents advantages to our generation.

**Evaluating National Debt**

Because debt plays such an integral part of economic progress, it must be measured appropriately to convey the long-term impacts it presents. Unfortunately, evaluating the country's national debt in relation to the country's gross domestic product (GDP) is not the best approach. Here are three reasons why debt should not be assessed in this manner.

**1. GDP is too complex to make a relative comparison of an acceptable national debt level.**

In theory, GDP represents the total market value of all final goods and services produced in a country in a given year. Based on this definition, one has to calculate the total amount of spending that takes place in the economy in order to estimate the country's GDP. One approach is the use of the Expenditure Method, which defines GDP as the sum of all personal consumption for durable goods, nondurable goods and services; plus gross private investment, which includes fixed investments and inventories; plus government consumption and gross investment, which includes public-sector expenditures for services such as education and transportation, less transfer payments for services such as social security; plus net

exports, which are simply the country's exports minus its imports. Given this broad definition, one should realize that the components that make up GDP are hard to conceptualize in a manner that facilitates a meaningful evaluation of the appropriate national debt level. As a result, a debt-to-GDP ratio may not fully indicate the magnitude of national debt exposure.

Therefore, an approach that is easier to interpret is simply to compare the interest expense paid on the national debt outstanding in relation to the expenditures that are made for specific governmental services such as education, defense and transportation. When debt is compared in this manner, it becomes plausible for citizens to determine the relative extent of the burden placed by debt on the national budget.

**2. GDP is very difficult to accurately measure.**
While the national debt can be precisely measured by the Treasury Department, economists have different views on how GDP should actually be measured. The first issue with measuring GDP is that it ignores household production for services such as house cleaning and food preparation. As a country develops and becomes more modern, people tend to outsource traditional household tasks to third parties. Given this change in lifestyle, comparing the GDP of a country today to its historical GDP is significantly flawed, because the way people live today naturally increases GDP through the outsourcing of personal services.

Moreover, GDP is typically used as a metric by economists to compare national debt levels among countries. However, this process is also flawed because people in developed countries tend to outsource more of their domestic services than people in non-developed countries. As a result, any type of historical or cross-border comparison of debt in relation to GDP is completely misleading.

The second problem with GDP as a measurement tool is that it ignores the negative side affects of various business externalities. For example, when companies pollute the environment, violate labor laws or place employees in an unsafe working environment, nothing is subtracted from GDP to account for these activities. However, the capital, labor and legal work associated with fixing these types of problems are captured in the calculation of GDP.

The third problem with using GDP as a measurement tool is that GDP is greatly impacted by technological advances. Technology not only increases GDP, but also improves the quality of life for all people. Unfortunately, technological advances do not take place in a uniform manner each year. As a result, technology may skew GDP upward during certain years, which in turn may make the relative national debt level look acceptable, when in fact it is not. Most ratios must be compared based on their change through time, but GDP fluctuations result in errors of calculation.

**3. The National Debt is not paid back with GDP.**
The national debt has to be paid back with tax revenue, not GDP, although there is a correlation between the two. Using an approach that focuses on national debt on a per capita basis gives a much better sense of where the country's debt level stands. For example, if people are told that debt per capita is approaching $40,000, it is highly likely that they will grasp the magnitude of the issue. However, if they are told that the national debt level is approaching 70% of GDP, the magnitude of the problem will not be properly conveyed.

Comparing the national debt level to GDP is akin to a person comparing the amount of their personal debt in relation to the value of the goods or services that they produce for their employer in a given year. Clearly, this is not the way one would establish their own personal budget, nor is it the way that the federal government should evaluate its fiscal operations.

**How the National Debt Affects Everyone**

Given that the national debt has recently grown faster than the size of the American population, it is fair to wonder how this growing debt affects average individuals. While it may not be obvious, national debt levels directly affect people in at least five direct ways.

First, as the national debt per capita increases, the likelihood of the government defaulting on its debt service obligation increases, and therefore the Treasury Department will have to raise the yield on newly issued treasury securities in order to attract new investors. This reduces the amount of tax revenue available to spend on other governmental services, because more tax revenue will have to be paid out as interest on the national debt. Over time, this shift in expenditures will cause people to experience a lower standard of living, as borrowing for economic enhancement projects becomes more difficult.

Second, as the rate offered on treasury securities increases, corporations operating in America will be viewed as riskier, also necessitating an increase in the yield on newly issued bonds. This in turn will require corporations to raise the price of their products and services in order to meet the increased cost of their debt service obligation. Over time, this will cause people to pay more for goods and services, resulting in inflation.

Third, as the yield offered on treasury securities increases, the cost of borrowing money to purchase a home will also increase, because the cost of money in the mortgage lending market is directly tied to the short-term interest rates set by the Federal Reserve, and the yield offered on treasury securities issued by the Treasury Department. Given this established interrelationship, an increase in interest rates will push home prices down, because prospective home buyers will no longer qualify for as large of a mortgage loan, since they will have to pay more of their money to cover the interest expense on the loan that they receive. The result will be more downward pressure on the value of homes, which in turn will reduce the net worth of all home owners.

Fourth, since the yield on U.S. Treasury securities is currently considered a risk-free rate of return and as the yield on these securities increases, risky investments such as corporate debt and equity investments will lose appeal. This phenomenon is a direct result of the fact that it will be more difficult for corporations to generate enough pre-tax income to offer a high enough risk premium on their bonds and stock dividends to justify investing in their company. This dilemma is known as the crowding out effect, and tends to encourage the growth in the size of the government, and the simultaneous reduction in the size of the private sector.

Fifth, and perhaps most importantly, as the risk of a country defaulting on its debt service obligation increases, the country loses its social, economic and political power. This in turn makes the national debt level a national security issue.

**The Bottom Line**

The national debt level is one of the most important public policy issues. When debt is used appropriately, it can be used to foster the long-term growth and prosperity of a country. However, the national debt must be evaluated in an appropriate manner, such as comparing the amount of interest expense paid to other governmental expenditures or by comparing debt levels on a per capita basis