

NATIONAL SECURITY IMPLICATIONS OF LONG-TERM DEFICIT SPENDING

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USAWC STRATEGY RESEARCH PROJECT

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by

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ABSTRACT

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Continued deficit spending by the federal government poses a risk to national security. As the national debt grows, interest payments consume an increasing proportion of the federal budget each year, crowding out discretionary spending. The DoD spends the largest proportion of discretionary budget, and as such, stands to absorb significant reductions in the future based on increasingly non-discretionary debt service and entitlement spending. This research paper explores the impact of ongoing deficit spending in terms of future defense budgets, investor confidence and interest rates, the economic impact of competition for financing, implications for international influence and potential financial leverage of creditors, and our ethical responsibility to future generations. The United States economy is in a downward financial spiral that needs to be addressed near-term to prevent future potentially catastrophic consequences.

NATIONAL SECURITY IMPLICATIONS OF LONG-TERM DEFICIT SPENDING

Federal Government Debt

The United States government faces a very sizeable and growing national debt problem. The debt is primarily the result of several decades of accumulated and accelerating deficit spending, where government spending has far exceeded tax revenues. Given the lack of political debate, it is evident that many Americans do not appreciate the long-term ramifications of the national debt problem, either in terms of impacts on our economic strength or on our national security. While an acute crisis may not lie ahead, storm clouds on the horizon portend a diminished capability to exert influence and respond to emerging issues in the international arena. In particular, the growth in entitlement spending due to the impending retirement of the baby-boom generation poses a significant challenge given existing deficits and accumulated debt. The United States government must take action near-term to begin the process of restoring fiscal responsibility so that our great nation may continue to protect its citizens, improve its standard of living, and exert influence internationally.

As of February 2010, United States gross federal debt hovers just above \$12.3 trillion,¹ a figure that is difficult to comprehend. This debt will balloon even higher as the federal government continues efforts to stabilize the economy, stimulate growth, and extend health care benefits to all Americans. Instead of focusing on gross federal debt, this research paper focuses on debt held by the public. The public includes banks, private citizens (e.g., savings bonds), private institutions (e.g., pension and mutual funds), state and local governments, and foreign investors. Debt held by the public represents “the measure of debt that has actually been sold in credit markets, and

which has influenced interest rates and private investment decisions.”² Of the \$12.3 trillion gross federal debt, the public holds \$7.8 trillion and the United States government holds the remaining \$4.5 trillion, primarily via trust fund investments like social security.³

Perhaps the best way to understand the size of federal deficits and debt is not strictly in dollar terms but rather as a percentage of total Gross Domestic Product (GDP). GDP attempts to measure the value of a country’s annual economic output for both goods and services. GDP comparisons are useful because they provide a snapshot of the magnitude of the economic drain on society caused by financing debt, both in times of economic prosperity and in recession. In theory, the nation can sustain high debt payments indefinitely, as long as the economic growth rate exceeds the rate of growth in debt. Similarly, if the nation experiences very high levels of inflation for extended periods, the debt burden will diminish as payments can be made more easily with cheaper dollars. For reference, tables below show national debt and deficits as a percentage of GDP from 1940 to 2010 to help demonstrate their relative magnitude.

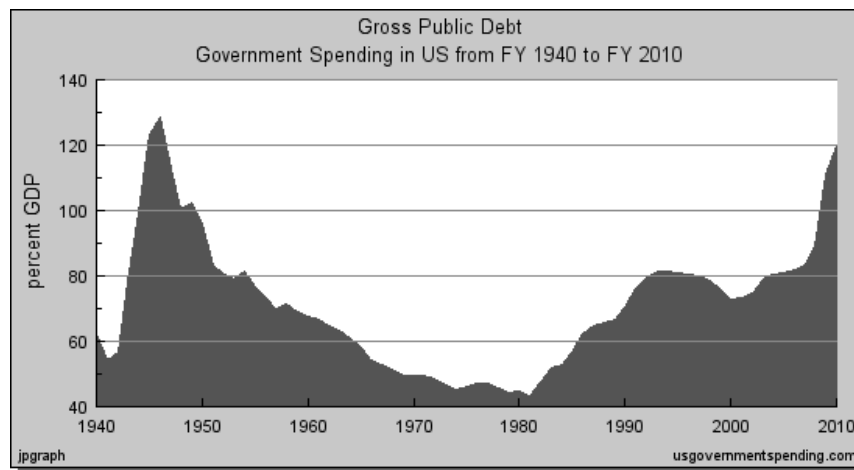


Table 1: ⁴

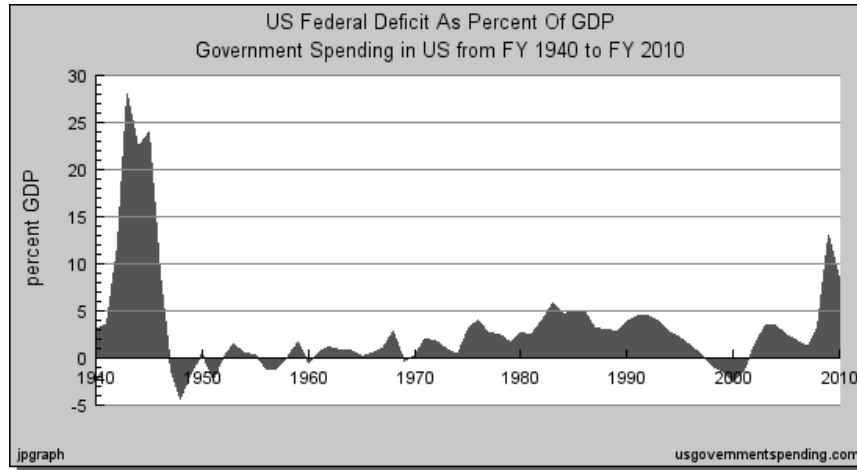


Table 2: ⁵

Background

One might ask how we got where we are today. From the beginning of the republic, the federal government ran budget deficits to help finance the Revolutionary War. Deficits reoccurred across the years as needed to help the nation weather major crises such as the American Civil War, and World Wars I and II. From 1789 to 1930, the United States ran deficits only forty-five times.⁶ “Almost all of them were associated with the country’s major wars, when governments traditionally borrow to finance a national emergency.”⁷ These deficits were sporadic and the government offset them by running surpluses across most of this same time period. Public debt soared to 114 percent of United States GDP during World War II (the largest debt to GDP ratio in history) but then grew only marginally, “by an average of less than \$2 billion a year” until about 1970.⁸ This growth rate represents a significant decline when measured against GDP over the same time period due to robust economic growth in the 1950s and 1960s. After World War II, the United States ran deficits more often than it ran surpluses, and deficits grew particularly fast from about 1980 to present. These deficits can be attributed to several major factors – recessions, inflation and sluggish growth, oil price

shocks, the defense build-up under Ronald Reagan and concurrent tax cuts, the global war on terror – but most importantly, the steady growth in entitlements. Because entitlements represent mandatory spending and consume an increasing proportion of federal spending each year, we have put ourselves in a box. What is particularly striking about recent debt accumulation is the increasing pace. While it “took the country 186 years to reach \$500 billion in red ink,”⁹ our national debt has increased nearly 20-fold in the ensuing three decades.

One should focus on entitlements since they represent close to 60 percent of federal spending and will consume an ever increasing share of the budget in the future.

A *New York Times* financial columnist recently noted that

record government deficits have arrived just as the long-feared explosion begins in spending on benefits under Medicare and Social Security. The nation’s oldest baby boomers are approaching 65, setting off what experts have warned for years will be a fiscal nightmare for the government.¹⁰

The United States faces a perfect storm of bad fiscal realities – locked-in entitlement payments for an aging population, a significant and persistent economic downturn (that has and will reduce tax revenues), and an enduring global war on terror. As a consequence, deficits will continue to move in the wrong direction for the foreseeable future.

Entitlement programs are largely, but not entirely, the legacy of two American presidents, Franklin D. Roosevelt and Lyndon B. Johnson. Each greatly expanded the role of government by creating major new social programs designed to provide financial security under initiatives known as the “New Deal” and “Great Society”, respectively. Because of the popularity of these new entitlement programs, several subsequent administrations continued to maintain and expand benefits. Politicians recognize they

run the risk of political suicide should they try to reduce or repeal benefits once extended. In fact, the late Speaker of the House, Tip O'Neil, referred to entitlements as the "third rail of politics" for this very reason. So, the United States has placed itself in an untenable position, having promised very costly social benefits to individuals predicated on an unsustainable model that requires continued growth in the employed population to support retirees and reasonable inflationary costs. It should be noted here in passing that other changes in addition to entitlement programs also played a part in growing the federal debt. For example, several administrations reduced revenue by changing tax policy, and new financial instruments were invented to sell debt securities to financial markets – creating the capability to finance large debts. Regardless, entitlement spending represents the primary cause of deficits and debt.

Social Security, Medicare and Medicaid are the most costly entitlement programs. Other entitlement programs include most Veterans' Administration programs, federal employee and military retirement plans, unemployment compensation, food stamps, and agricultural price supports. With respect to the three largest federal government entitlement programs, the Congressional Budget Office (CBO) recently forecasted that the combined effect of the aging population and excess cost growth in health care spending will drive these programs up approximately 6 percent of estimated GDP from 2009 to 2035.¹¹ The concern is significant because growth in these programs will dramatically increase the debt, assuming tax revenues do not grow at a corresponding rate. As reflected in table 1 above, "Federal debt is already very large relative to GDP by historical standards."¹² We are on an unsustainable path that is made even more problematic because of increased polarization in American politics.

We find “Democrats more set on defending entitlements and Republicans determined to hold down taxes.”¹³ This polarization impedes the teamwork needed to solve one of our greatest long-term national security challenges.

Budgetary Implications of Deficits and Debt

The table below provides a graphic representation of the FY2010 federal budget broken between entitlement spending (health, pensions and welfare), defense discretionary spending, and all other discretionary spending (to include debt service).

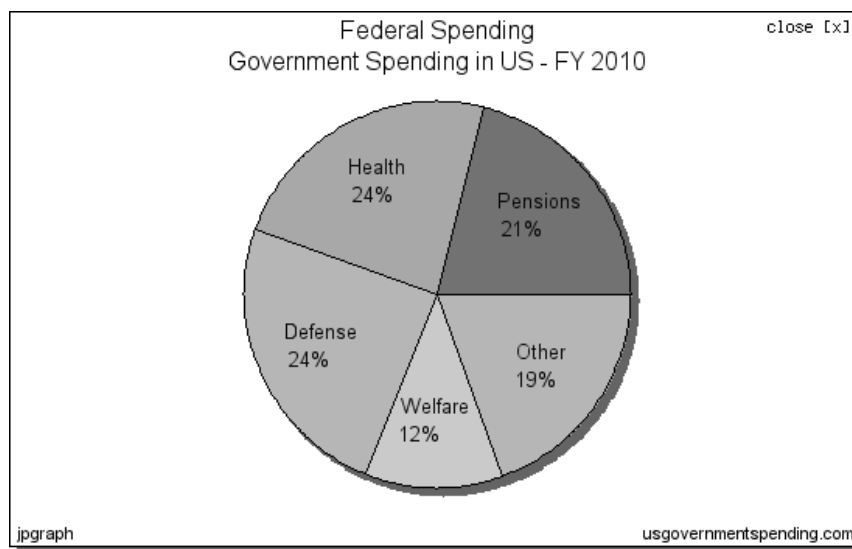


Table 3:¹⁴

Entitlements comprise the largest slice of the budgetary pie at 57 percent. As discussed above, the expectation is that this portion of the budget will grow substantially in the coming years. In parallel, debt service will also grow as we struggle to finance growing entitlement payments. The “White House estimates that the government’s tab for servicing the debt will exceed \$700 billion a year in 2019, up from \$202 billion this year, even if annual budget deficits shrink drastically. Other forecasters say the figure could be much higher.”¹⁵ “Rising debts also force the government to divert tax revenue from public services to interest payments. The CBO estimates that by 2019 interest on

the national debt will consume 3.8 percent of GDP, more than twice its share earlier this decade.”¹⁶ To further illustrate the magnitude of debt service payments, “by 2019 they will exceed defense spending.”¹⁷ This raises a fundamental concern regarding our nation’s ability to fund essential government services and programs, not to mention emergent requirements related to defense, disaster relief, and economic stimulus measures. The budgetary outlook is grim as we see major growth in entitlements and debt service payments on the horizon. This leaves discretionary spending as the inevitable outlet for intense budgetary pressures. As a consequence, programs funded by discretionary spending may not grow in response to major crises or new initiatives on either the domestic or international fronts – unless the government increases the debt (creating a downward financial spiral), makes cuts in other programs, or imposes large tax increases. Absent significant and sustained economic growth, defense budgets will likely shrink in the coming years as will other discretionary programs. Without doubt, the government will face limited flexibility and fewer options in the future.

For much of the last three decades, the government has relied on deficit spending to cover operating expenses. While most economists would agree that deficit spending is an indispensable stimulus tool during recessionary periods, deficit spending cannot persist indefinitely if the economic growth rate and tax revenue lag the rate of increase in deficit spending. By perpetuating this fiscal *modus operandi*, we have unwittingly limited our strategic flexibility. The United States will be more vulnerable when inevitable shocks and strategic surprises develop within the international system. As has been the case throughout our history, there will be national emergencies, and “it is because emergencies will surely arise that the borrowing capacity of the nation

should not be utilized for operating expenses”.¹⁸ Normal operating expenses should be fully funded with current tax revenues in order to preserve borrowing capacity for future crises. There is no free lunch. “The nation needs to develop a new consensus about how much it wants to spend, and for what. This means a debate on the roles of the state in the economic and social life of the nation.”¹⁹ Otherwise, we live beyond our means and are jeopardizing future generations by our overconsumption.

Financing the Debt

To further understand some of the problems associated with high national debt, an understanding of how the government goes about raising funds to finance the debt is important. The Department of the Treasury is the arm of the federal government charged with attracting buyers and arranging the sale of debt instruments. More specifically, the Bureau of the Public Debt within the Department of the Treasury performs this function. Debt instruments may take one of several forms, including Treasury bills, notes, bonds, and inflation protected securities. The primary distinction between types of federal debt instruments is the length of time they require to mature and how much interest must be paid over time to investors. Naturally, the longer the time horizon, the higher the interest rate will be because of the increased risk assumed by the lender. Bills mature in one year or less, notes mature in two to ten years, and bonds mature in twenty to thirty years. Inflation protected securities, also known as TIPS, are sold in varying maturities and are indexed to the rate of inflation, thereby guaranteeing a certain rate of return above the rate of inflation. Each type of Treasury security is liquid. Securities may be purchased directly from the Treasury and are also bought and sold on secondary markets.

As the United States continues to run up deficits and debt, the Treasury must continue to find new sources of financing or enforce more strict revenue collection (via tax enforcement). The Bureau of the Public Debt advertizes the sale of Treasury securities required to finance new debt as well as to roll over any existing debt that has matured and is still outstanding. The Bureau sells these securities by conducting sealed bid auctions. For reference, public debt is held by a multitude of sources, foreign and domestic, public and private, as reflected in the following table from June 2009:

(\$ in billions)													
	Total public debt	Federal Reserve and Intragovernmental		Total privately held	Depository institutions	U.S. savings bonds	Pension funds			Mutual funds	State and local governments	Foreign and international	Other investors
		mental holdings					U.S. Private	State and local governments	Insurance companies				
June 2009	11,545.3	5,026.8		6,518.5	145.4	193.6	312.5	177.7	162.2	694.5	528.3	3,382.1	922.2

Table 4:²⁰

In part because of the financial crisis and associated government stimulus actions, the United States faces a sizeable amount of short-term debt maturing in the next one to three years. About 36 percent of public debt – roughly \$1.6 trillion – will come due within a year, and another \$3.5 trillion will be needed over the next three years.²¹

Although these amounts are staggering, the United States government was forced recently to finance as much as \$7 trillion of new and maturing debt. To accomplish this feat, “the Treasury held an auction on average more than once a day” during FY2009.²²

Other Implications of Large Deficits and Debt

The question one must consider is how much additional United States government debt international and domestic investors will absorb before reaching a tipping point, particularly since the Federal Reserve has kept interest rates artificially

low for an extended period of time. Investors must weigh questions regarding risk and return as well as consider the attractiveness of competing investment opportunities. Because investor behavior involves psychology and assumptions about future economic growth, nobody knows where the tipping point will be. Undoubtedly, the more debt the United States compiles, the more upward pressure that debt will exert on interest rates. In addition to Federal Reserve policies, two other factors help hold interest rates artificially low in the near-term. First, many central banks throughout the world buy and hold dollars as a reserve to hedge against risk in their own currencies. Second, oil is denominated in dollars on international markets. Dollars currently dominate because they represent the economic and political strength of the United States. This arrangement provides us with a unique level of flexibility; however, it should be noted that although dollars enjoy a form of global hegemony, this situation could change as has happened throughout history with the rise of new global powers. China recently advocated for the creation of a global market basket of currencies to be used as a reserve currency instead of the dollar to help mitigate the impact of future financial crises.²³ While such a change may ultimately come to pass, it is unlikely to affect interest rates in the near term (although it adds a bit of uncertainty). What is more likely to affect interest rates in the near-term is simply the scale of financing required to sustain growing United States deficits, the expected risk of bond default (little), and the outlook for economic prosperity (as impacted by the recent housing collapse and credit crunch). Ultimately, the fear is we “could well exceed the absorption capacity of Asian central banks for dollar holdings.”²⁴ What many fail to understand is that “foreigners would only need to slow their dollar purchases to cause the US financial distress.”²⁵ In

addition to reliance on foreign investors, international trade deficits can contribute to devaluation of the dollar, driving subsequent interest rate increases in order to attract capital. Fundamentally, the model the United States uses to finance its ravenous credit needs is unsustainable in terms of international absorption capacity and may risk costly interest rate increases in order to attract necessary buyers.

The government needs investor confidence, yet it can be difficult to sustain long-term. If, under whatever circumstances, the government is unable to find adequate buyers of its debt securities, it would be forced to sell securities to itself (over and above what it already self-finances from Social Security tax receipts). This action would equate to printing additional money, leading to inflation based on devaluation of existing dollars. Dollar devaluation would make investors less willing to invest in dollar denominated securities, so the government would be forced to boost interest rates to attract new buyers. The potential for such a downward spiral is real. Another important consideration is that if global investors lose confidence in the value of the dollar and dump it in favor of some other currency or commodity (such as oil or gold), “a self-fulfilling stampede could trigger sell-offs in U.S. stocks and bonds. People have predicted such a crisis for decades. It hasn’t happened yet...But something could shatter that confidence, tomorrow or 10 years from tomorrow.”²⁶ So long as the government is able to sustain investor confidence, it will be able to borrow. If, on the other hand, investor confidence lapses, whether based on something tangible or simply anxiety about the government’s huge borrowing needs, interest rates would rise and could plunge the world into another global financial crisis.

In addition to concerns over investor confidence, another problem threatens the long-term economic picture. This problem, known as “crowding out”, involves competition between the public and private sectors for financing. Understandably, the private sector needs ready access to capital at reasonable interest rates, but because of the magnitude of federal deficits, “voracious government demand for credit crowds out industry’s demands for money to invest for expansion.”²⁷ Crowding out occurs when the available pool of creditors chose to lend their money to the government instead of buying corporate bonds or when businesses are forced to offer more generous terms than they would otherwise choose in the absence of government competition. The private sector simply cannot compete against the federal government with its seemingly insatiable need for credit. “Publicly held debt, just 37% of GDP two years ago, has already jumped to 56%.”²⁸ Persistently large deficits and debt will not only raise long-term interest rates, but will also crowd out private sector investment and stunt long-term economic growth.²⁹ The private sector faces a particularly challenging environment today with “tight” credit markets brought about by the housing bubble that rippled through other parts of the economy.

Just as individual investor confidence is a key to economic growth, private sector concerns also must be weighed. If businesses foresee higher taxes in the future, they may be less likely to take expansionary measures. “Uncertainty over how taxes may be raised to shrink deficits may already be weighing on business confidence. Worries about inflation or default could start to push up interest rates. Eventually, private investment will be crowded out.”³⁰ As businesses reign in expansionary measures, job

creation and economic growth will stall, and this stagnation will impede the ability of the government to grow its way out of the deficit conundrum.

Concerns over crowding out and shaky business confidence also could threaten the health of the defense industrial base and increase the cost of acquisition. Just like other businesses, defense contractors require access to credit to finance research and development activities and major construction and retooling. In particular, research and development in high technology programs poses risk and expense. Companies could start to shy away from these efforts due to the cost of obtaining capital. These same companies will likely see fewer major acquisition programs in the future given competing demands for government discretionary funding. Uncertainty over the size and duration of future acquisition programs will force bidders to increase their bids to cover the cost of capital. In a worst case scenario, the cost of capital could limit the number of viable bidders. This lack of competition will inevitably drive up acquisition costs for the government. The House Appropriations Committee of the Congress recently expressed concern over the lack of competition in the Air Force tanker acquisition to replace the aging KC-135 and included specific language in a report accompanying the 2010 defense appropriation bill to try and ensure that two corporations remain viable suppliers. The committee said that "having more than one aircraft provider will allow for competition to help control the procurement cost, promote cost reduction measures, and allow for a faster aircraft replacement rate".³¹ The Department of Defense needs a healthy industrial base to help minimize the cost of major acquisition programs.

In addition to concerns over the industrial base, the United States requires a strong economy to retain its ability to influence internationally. “The ability of any state to dominate in the international system depends on its economic strength.”³² A strong economy supports a strong military, and a strong military supports statecraft. The problem the United States faces now and in the future is that past decisions on debt increasingly limit the ability of the government to maneuver economically.³³ In previous years, the government was able to deal with national emergencies such as war by running large deficits. Now the government runs large deficits to maintain the status quo – and will be forced to increase deficit spending in the future to support unfunded liabilities associated with entitlement spending. As the United States increasingly relies on debt to meet its obligations, it “leaves the country more exposed to shocks and more vulnerable to the financial leverage of its creditors.”³⁴ The United States has been at war since September 2001 and will be at war for the foreseeable future. The current global war on terror could last for decades just like the Cold War. We must recognize the new status quo and work to finance defense and other requirements within existing budgetary authority with no or very limited deficit spending.

The potential financial leverage of creditors is a growing concern from a national security perspective. Any nation should be concerned if its ability to act internationally could be compromised based on who owns its debt or who might be needed as a creditor in the future. “America is like no other dominant power in modern history – because it depends on other countries for capital to sustain its military and economic dominance.”³⁵ The following table shows how much public debt is owned by various countries. Note that data below (from November 2009) reflect 6 percent growth in the

amount of foreign owned debt over only five months when compared to table 4 (from June 2009).

Major Foreign Holders of Treasury Securities
(in billions of dollars)
Holdings 1/ at end of November 2009

China, Mainland	789.6
Japan	757.3
United Kingdom 2/	277.5
Oil Exporters 3/	187.7
Carib Bnkng Ctrs 4	179.8
Brazil	157.1
Hong Kong	146.2
Russia	128.1
Luxembourg	91.7
Taiwan	78.4
All Other	804.1
Total	3,597.5

1/ Estimated foreign holdings of U.S. Treasury marketable and non-marketable bills, bonds, and notes reported under the Treasury International Capital (TIC) reporting system are based on annual Surveys of Foreign Holdings of U.S. Securities and on monthly data.

2/ United Kingdom includes Channel Islands and Isle of Man.

3/ Oil exporters include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya, and Nigeria.

4/ Caribbean Banking Centers include Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, Panama and the British Virgin Islands.

Table 5:³⁶

As shown, China and Japan own a sizeable proportion of United States public debt. At some point, we must recognize that Asian central banks will own as much United States debt as they wish to hold. There is a finite limit to their appetites. When they reach this point, they may stop buying United States debt, slow their purchases, or sell. Any of these scenarios will likely cause financial distress and could “have implications for America’s global power”.³⁷

There are probably a multitude of what-if scenarios one could explore in terms of how United States global power could be compromised by its mountainous debt. Certainly China could attempt to exert influence on the United States by either

threatening to halt purchases of additional securities or by threatening to dump securities at whatever price achievable in the global marketplace. They would undoubtedly take a hefty loss under this scenario, but it is within the realm of the possible. It is unclear to what extent the United States would govern its actions in the international arena based on Chinese threats. We could find ourselves constrained in dealing with a Taiwanese or North Korean contingency because of our dependence on China's continued purchase of Treasury securities. In a worst case scenario, "if the US came to regard China as a strategic threat in East Asia, its capacity to enhance its regional security interests would encounter the paradox of partial dependence on China's ongoing funding of its defense-related deficit spending."³⁸ While this scenario could play out, the relationship with China in the near-term is a codependent one. The United States needs China to continue buying debt securities and China needs the United States to stave off inflationary pressures so that the value of its holdings remain strong. As one Chinese economist with the Chinese Academy of Social Sciences put it, "China will not take any irrational action. We don't want to hurt you – because if we hurt you, we hurt ourselves first. It's a kind of synergy."³⁹ In the current environment, it is unlikely China would begin a sell-off of its position in United States securities because of the financial losses involved and because dumping dollar holdings would increase the price of Chinese exports to United States consumers. This action could cause China's export dependent economy to tank. This mutual dependence, at least at present, benefits both parties.

The question remains open as to whether or what future circumstances might change the nature of this synergistic relationship to one where China would in fact act

against United States financial interests. Certainly nobody knows exactly what type of relationship the United States and China will have in the future. The relationship could be one of mutual economic competition, or it could be one of perceived threats and military confrontation much like the Cold War. Sooner or later, the United States must come to grips with the fact that it cannot continue piling debt upon debt, if for no other reason, because of the potential for undue foreign influence. The United States government's inability to responsibly address its increasingly precarious fiscal situation can be characterized as a failure of leadership. Without doubt, it is far better to "avert a potential economic crisis than run the risk of dealing with the consequences of a real one."⁴⁰ Although the current economic downturn is not the time to reign in large deficits precisely because they are needed to help stimulate economic growth, the United States must take action in the near future to ensure that it retains its global position and restore financial stability. "Unless the United States quickly achieves and maintains a sustainable economic position, its ability to pursue autonomous economic and foreign policies will become increasingly compromised."⁴¹

Generational Equity

Thus far this research paper has discussed potential national security implications of large deficits and debt. Potential national security implications have been attributed to increasing entitlement spending and debt service payments (both working to squeeze out discretionary defense spending), decreasing investor confidence and implications for long-term interest rates, the impact of "crowding out" on private sector investment and the associated economic drag, and the danger of too much foreign influence based on increased borrowing from abroad. This paper now turns to moral considerations related to generational equity. While this area of focus

lacks direct near-term national security implications, current deficit spending will most certainly constrain the flexibility of future generations to deal with emerging national and international crises. Should another major crisis occur like the United States faced in World War II, such as a terrorist sponsored mass casualty event, future generations will find it extremely difficult to sustain the large deficits needed to respond.

For years, the United States has been unwilling to fully fund government services and promised benefits from current resources. This overconsumption is a moral issue that leaders must face. Perhaps Thomas Jefferson summed up the situation best when he said, “The laws of nature made it unfair to impose the debts of one generation upon another.”⁴² This is exactly the situation imposed by current government financial practices. The situation would be a bit different on the other hand if, instead of using deficits to fund operating expenses or redistributing income under minimally productive programs, we used deficits to fund capital investments that paid long-term dividends to our successors. Rather than increasing the debt burden on our children and grandchildren and limiting their flexibility to respond to crises, modest deficits to support capital investments could promote long-term economic growth. This spending could improve physical and human capital, “and technologies that increase potential GDP and the standard of living”⁴³. At least one expert has observed that, “After decades of neglect of the nation’s infrastructure, attractive public investment opportunities abound”.⁴⁴ These investment opportunities could and should focus on those with highest positive net present value. If we take such an approach to deficit spending, our heirs will be better off instead of worse off. These actions are particularly important because, “(t)he ultimate test of a society is the kind of world it leaves to its children.”⁴⁵

Potential Solutions

The natural question is what the United States can and should do to begin climbing out of the debt conundrum. Answers are not easy. Americans must come to understand that,

The country faces a fundamental disconnect between the services people expect the government to provide, particularly in the form of benefits for older Americans, and the tax revenues that people are willing to send to the government to finance those services. The fundamental disconnect will have to be addressed in some way if the budget is to be placed on a sustainable course.⁴⁶

There are four possible approaches for consideration. The first approach involves a combination – of raising taxes and cutting government services. While this approach is logical, it is politically unpalatable. There are no apparent major constituencies for fiscal responsibility on the part of the federal government; however, there are many constituencies when it comes to increased taxation and reduced government services. The second approach involves allowing and actively promoting inflation. While this approach would marginally erode the value of outstanding debt, it would hurt creditors and consumers alike. Hurting creditors would be a short-term solution to a long-term problem, and hurting consumers would be politically problematic. The third approach would be for the United States simply to default on its debt obligations. The problem with this approach is that it would likely instigate worldwide economic panic of unseen proportions and would also be a short-term solution in the sense that the United States would find it extremely difficult to obtain adequate credit in the future absent significant interest rate increases. The fourth approach would be for the United States to grow its way out of debt – expanding the economy would generate additional tax revenues. Although every politician and economists dream, this approach would likely require

years of sustained economic expansion unlike anything before experienced. In contrast, the debt has grown much faster than the economy for years. Perhaps a liberal immigration or guest worker program could help provide additional labor needed to finance growing entitlements for the baby-boom generation. For example, the United States could actively promote immigration, quickly grant citizenship, and then tax new citizens; however, such a policy shift would likely come with negative political repercussions and would be a partial solution at best. Of the four approaches presented, only the first represents a responsible and proactive method for dealing with the fiscal problems the United States faces. This is an unfortunate reality. “Stabilizing debt as a share of GDP requires some combination of faster economic growth, higher taxes, or lower spending.”⁴⁷ To accomplish this task, the United States needs unprecedented political leadership – leaders from both parties who are willing to put the long-term needs of the country ahead of political ambition. This will be difficult to achieve absent some clear and present danger. Unfortunately, the dangers we face down the road are real, and we have little choice in terms of options.

Unless driven to take action by some external focus such as a catastrophic event, it is unlikely politicians will address the debt problem in a meaningful fashion anytime soon. As mentioned above, there is no major constituency for fiscal restraint. Instead, “the appetite for power and prestige motivates behavior in most of them”, and they must concern themselves with getting reelected.⁴⁸ This is the unfortunate reality of our political system. Perhaps the single best approach for applying leverage to the problem would be to advocate for an independent commission to study the problem and recommend concrete solutions. Politicians then would get an up or down vote using the

same approach as past Defense Base Realignment and Closure commissions. “The statutory creation of a ‘fiscal future commission’ modeled on the Defense Base Closure and Realignment Commission, a federal body whose recommendations are subject to an up-or-down vote in Congress – could represent a major breakthrough.”⁴⁹ This approach likely would focus attention on several areas of opportunity.

An independent commission should take a comprehensive approach to examining the debt problem – looking at both the tax structure and existing government programs. Regarding solutions, finding ways to contain long-term medical costs probably represents the biggest target of opportunity. Like it or not, government intervention will be needed to push forward this agenda. Medical cost growth has far outpaced standard inflation for quite a few years. This is unsustainable from the perspective of having to provide government services. In addition, we need Social Security reform. Reforms could include gradually increasing the retirement age further, indexing benefits based on income, and altering the benefits formula based on price increases rather than wages. Although a difficult sell, we need to remember that Social Security was originally intended to be a social safety net. Perhaps not all citizens should qualify for full benefits. If medical cost containment and Social Security reforms are phased in over a period of years or decades, changes could shave several percentage points of GDP off the deficit.⁵⁰ A third measure to consider would be “raising taxes on consumption, which would both generate needed revenue and provide new incentives for private saving”.⁵¹ Some have also advocated for a flat tax on those making above a certain income threshold. A flat tax could be used to broaden the tax base and would have the benefit of being more transparent, understandable, and fair –

all important factors in winning popular support. It remains unclear though whether the country could stomach both a consumption tax and a flat tax, although there is precedent for multiple taxes if we consider state and federal taxes levied on gasoline. The commission should also explore the benefits of such procedural changes as granting the President line-item veto power (or some sort of congressional procedure to minimize earmarks) and implementing “pay-as-you-go’ rules, which require that all increases in spending or tax cuts be financed by savings elsewhere in the budget”.⁵² Fundamentally, the people of the United States need to have a fair and open debate about what services and programs we wish to provide for our nation. As part of that debate, we must be prepared to pay for these programs and services from current resources. Otherwise, we continue to live in a financial fantasy world.

Conclusion

The United States government must take action to begin the process of restoring fiscal responsibility. The problem materialized over decades and will not be solved overnight, but if we continue to ignore the problem, negative consequences will develop in the not-too-distant future. These problems include the erosion of defense and other discretionary budgets, diminished economic power and international influence, and fewer options to deal with emergent crises. The United States must get its financial house in order, if for no other reason, because a strong military requires a strong economy to support it. As tough as it may be, politicians must exert the kind of leadership that transcends partisanship in order to find a viable long-term solution. Similarly, United States citizens must face up to the reality that very difficult choices lie ahead. There will be pain, but to do nothing is not an option. The economic prosperity and might of the United States hang in the balance.

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