OF DEFICITS AND DEBT SERVICE

Thomas J. Pierce

Introduction

While opinion differs regarding the overall economic impact of large federal government deficits, their effect on the cost of servicing the public debt has been obvious and dramatic. Annual federal government deficits in the neighborhood of \$200 billion have driven up the volume of public debt, with the associated interest bill ballooning accordingly. Net interest¹ is now the third largest of twenty functional categories of federal government spending.

In this paper the impact of federal government budgetary policy on deficits, the public debt and net interest payments during the Reagan Administration is examined. Large deficits are shown to inflate the public debt and increase the annual cost of debt servicing. This rapidly rising net interest burden, combined with political aversion to legislated tax increases and spending cuts, minimizes the possibility of significant deficit reduction and increases the probability that some form of balanced budget rule eventually will be adopted.

Deficits, Debt and Net Interest, 1981-1985

In his initial budget proposal in March 1981, President Reagan projected a balanced federal budget by fiscal year 1985. Many proposed spending cuts, however, were not effected and the 1982-83 economic recession depressed tax revenue and increased cyclical government spending. These factors combined to produce large deficits which caused a dramatic increase in the public debt and, correspondingly, net interest payments. The latter grew so rapidly from 1981 to 1985 that net interest itself contributed substantially to growing annual deficits.

Table 1 compares annual deficits and net interest outlays projected by the Reagan Administration in March 1981 with actual figures for fiscal years 1982 through 1985. The progressively widening gap between projected and actual deficits increased the public debt from \$794 billion in 1981 to more than \$1.5 trillion

1. Net interest is the difference between the federal government's cost of financing the public debt and the interest it receives from government trust funds and the public.

in 1985, driving a wedge between projected and actual net interest payments. This net interest differential became so pronounced that it accounted for almost 30% of the difference between the projected and actual 1985 deficits.

Table 1
Federal Deficits and Net Interest,
FY 1981-85
(billions of dollars)

	Deficits		Net Interest	
	Projected	Actual	Projected	Actual
1981	\$78.5	\$78.9	\$64.1	\$68.7
1982	61.7	127.9	68.2	85.0
1983	33.5	207.8	68.9	89.8
1984	9.0	185.3	67.8	111.1
1985 (est.)	0.7	222.2	64.9	130.4

Notes: a. deficit figures include both on-budget and off-budget outlays. b. 1985 figures are based on February, 1985 estimates.

Sources: U.S. Executive Office of the President, Office of Management and Budget, Fiscal Year 1982 Budget Revisions (March, 1981); and The Budget of the United States Government, Fiscal Year 1986 (February, 1985).

Net interest is now the third largest functional category of federal government outlays, trailing only national defense and Social Security and Medicare. After accounting for about 7% of federal government spending for over twenty years, net interest's share of total outlays began to rise in the mid-1970s, reaching 10.1% by 1981 and 13.6% in 1985. The increasing absorption of tax revenue into debt service focuses increased attention on Administration and Congressional unwillingness to legislate substantial tax increases and inability to effect significant spending reductions. This budgetary inertia has resulted in larger deficits and an ever larger debt service burden.

Deficits and Net Interest, 1986-1990

While the Deficit Reduction Act of 1984 made a small "down payment" on deficit reduction and President Reagan's 1985 budget message outlined a plan to reduce annual deficits steadily to \$82 billion by 1990, achieving deficit reduction is another matter. As with the March 1981 plan, current revenue projections seem

overly optimistic while the magnitude of proposed spending cuts stretches the imagination, given the generally unenthusiastic Congressional response to spending restraint proposals in recent years.

Among \$507 billion of proposed spending cuts² over the 1986-1990 period, only 10% would be in national defense. Discretionary programs,³ on the other hand, would absorb 40% of proposed cutbacks, and entitlements and other mandatory spending 29%. It is unlikely that such considerable reductions will be realized in the latter two categories. Real spending for discretionary programs declined from 1981 to 1985, adversely affecting the low income population. Accordingly, Congress seems unwilling to make further significant cuts in this area, especially in light of the 18% real increase in total federal government outlays over the same time period. Curtailing entitlements substantively is equally unlikely. While entitlements as a whole are perceived by some as a group of excessive welfare programs, means-tested entitlements providing cash benefits or services to low income people actually represent only 15% of all entitlement outlays.⁴ Significant entitlement savings, therefore, would require paring programs such as Social Security, Medicare, and federal civilian and military pensions, which largely benefit the middle class population. Few elected officials are willing to champion long term structural reforms which would curtail expenditures in these areas.

While the Administration's outlay projections appear understated, the opposite seems true of expected total receipts, which depend directly on the rate of economic growth. Real GNP is projected to grow 4% annually from 1985 to 1988, with slightly less growth in the following two years. Given an annual growth rate of just 1.1% during the first six months of 1985 and, more generally, average annual growth of 2.8% over the past 15 years,

2. Spending would not actually decline, but would be \$507 billion less than if current policies were unaltered.

3. This category includes programs ranging from basic federal government activities, such as the conduct of foreign affairs and the tax collection system, to grants to state and local governments for education, highway construction, and community development. It also includes foreign aid, space programs, law enforcement, energy, flood control, health research, and several direct loan programs.

4. U.S. Congress, Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1986-1990, February 1985, p. 59.

the 1986-1990 revenue projections are optimistic. Should actual growth approximate the historical trend, budget receipts will sag below projected levels. Viewed in conjunction with the apparent understatement of outlays, the magnitude of projected deficit reduction over the next several years is highly questionable.

Baseline projections of the nonpartisan Congressional Budget Office (CBO) for 1986 to 1990 reflect a less rosy, seemingly more realistic budgetary scenario. Assuming constant real spending on non-defense discretionary programs, and defense spending rising as stipulated in the fiscal 1985 Congressional budget resolution,⁵ the CBO projects budget deficits rising steadily from \$215 billion in 1986 to \$296 billion in 1990. Under these circumstances, the public debt would rise to \$2.8 trillion by 1990, three and one-half times its 1981 level. Net interest would account for 17% of total outlays. This gloomy outlook, it must be noted, is further predicated on the assumption that the economy will grow 3.2-3.4% annually from 1986 to 1990. A lower actual rate of growth would exacerbate the deficit-debt-interest burden cycle.

Conclusion

While there has been extensive discussion of fiscal responsibility during the Reagan Administration, the government has responded only passively to rising deficits. Expenditure and revenue projections, based on overstated political will and economic growth, have widely missed their marks, causing deficits to explode. The public debt, in turn, has accumulated so rapidly that mandatory net interest payments absorb an ever expanding share of government receipts, further reducing budgetary flexibility. Viewing this rising debt service burden in conjunction with Presidential commitments to a strong national defense and lower taxes, and considering the inherent political difficulty of moderating increases in middle class entitlements or further limiting non-defense discretionary spending, large budget deficits will likely continue, forcing the eventual adoption of some form of balanced budget rule.

5. This resolution specifies defense budget authority for fiscal years 1986 and 1987. The CBO's 1988-1990 figures are an extrapolation of the 1985 resolution.

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