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Debt: A Threat to National Security?

by

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Abstract

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The gross federal debt now tops $18 trillion, but the outlook appears to be improving as the economy continues to rebound from the Great Recession. In 2014, the nation experienced its fastest economic growth in over ten years, the stock market doubled, the health care inflation rate was at its lowest rate in 50 years, and the deficit had been cut by two-thirds. But much debate remains before the actual debt improves. This paper aims to inform that debate by providing a general description about government debt, reviewing our nation's history and projections of debt, and describing the impact of debt on national security. Finally, it offers broad recommendations based on this context.

Debt: A Threat to National Security?

> By 2039, under the extended baseline, federal debt held by the public would reach 106 percent of GDP… equal to the percentage at the end of 1946 and more than two and a half times the average during the past several decades ... that trajectory ultimately would be unsustainable.
>
> —Congressional Budget Office[1]

Following on the heels of the damaging Great Recession, the 2010 National Security Strategy of the United States avowed, “Rebuilding our economy must include putting ourselves on a fiscally sustainable path.”[2] Four years later, the Congressional Budget Office (CBO) characterized the trajectory of the federal debt as “unsustainable.”[3] Since 2010, the gross federal debt has grown more than $4.25 trillion and tops $18 trillion.[4] But now there is some good news. President Obama’s 2015 State of the Union address highlighted areas of economic improvements to the American people: the nation had experienced its fastest economic growth in over ten years, the stock market had doubled, the health care inflation rate was at its lowest rate in 50 years, and the deficit had been cut by two-thirds.[5] Although these statistics all reveal positive economic trends, the fact remains that our budget still carries a deficit and deficits increase debt.

However, economic historian John Steele Gordon reminds us that Alexander Hamilton, the economic genius who founded our economic system, had the goal of establishing a national debt in order to expand the capacity of the fledgling economy. Gordon argues, “national debt, properly funded and serviced, can be used as a potent instrument of national policy,”[6] a tool to be leveraged to improve the economy or provide the government options to handle crises, reducing risk. As the debt climbs, those options become limited. Therefore, debt may be either good or bad, but less debt is typically considered better.

2015 may be an important inflection point. The recent economic recovery and the reduced-deficit budget proposals from the President and Congress, combined, could result in reduced levels of projected debt and associated security risk. But much debate remains before either proposal or a compromise proposal becomes law. This paper aims to inform that debate by providing a general description about government debt, reviewing our nation's history and projections of debt, and describing the impact of debt on national security. Finally, it offers broad recommendations based on this context.

Description of the Federal Debt

Debt can be categorized several ways. The term "national debt" refers to the sum of all federal, state, and local debt. "Gross federal debt" refers to the sum of outstanding bills, notes, bonds, and other debt issued by the U.S. Treasury and other federal agencies, such as the Tennessee Valley Authority. Gross federal debt includes "debt held by the public" and "debt held by government accounts."[7]

In nominal dollar terms, the gross federal debt exceeded $18.14 trillion as of December 31, 2014.[8] If measured in stacked dollar bills, it would wrap around the Earth's equator nearly 50 times or stretch more than five times the distance from the Earth to the moon.[9] $12.52 trillion of the gross federal debt is debt held by the public, consisting of Treasury bills, notes, bonds, U.S. savings bonds, etc. The other $5.62 trillion of the gross federal debt is debt held by government accounts, such as holdings in government trust funds, revolving funds, federal financing bank securities, etc.

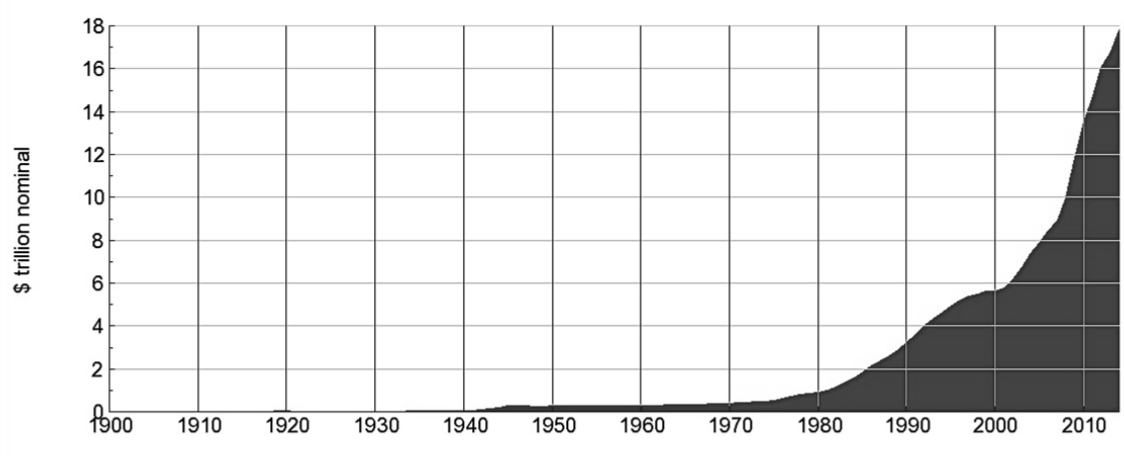

Figure 1. Gross Federal Debt, 1900 to 2014[10]

Figure 1 depicts the growth of the total federal debt since 1900 in nominal dollars. The rise of the debt in dollar terms resembles exponential growth, but this chart does not take into account the expansion of the U.S. economy, as depicted in Figure 2. With a larger economy, the government can bring in more revenue through taxation. In that sense, the government has an increased capacity to manage a higher debt. In order to make a useful comparison, we must analyze the debt in comparison to other relevant statistics rather than the raw dollar amount.

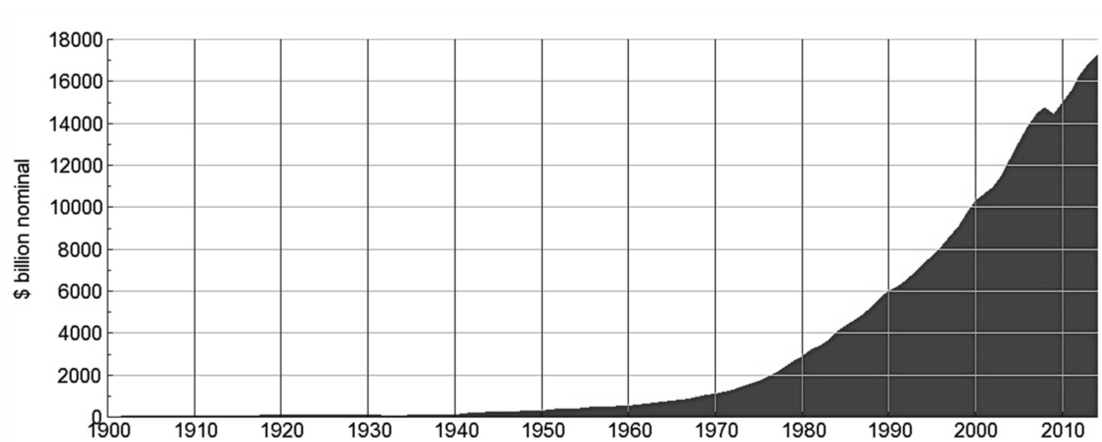

Figure 2. Real Gross Domestic Product, 1900 to 2014[11]

Economists typically describe the federal debt held by the public compared to the national gross domestic product (GDP) to make comparisons over time or comparisons between two or more countries.[12] Figure 3 shows a history of debt, ending at 74.1 percent of GDP in 2014.[13] This comparison readily indicates increased debt during or immediately after major conflicts or financial crises.

Anyone engaging in the debate over deficits and defense should first review the ebb and flow of the nation's debt between recessions and major conflicts in order to gain context of how the nation's leaders have regarded debt. This review may help shape decisions about what should be done to properly manage the debt and understand the effects of those decisions on the economy and the population.

History of the Federal Debt

The use of debt as an instrument of national policy in the United States solidified upon the ratification of the Constitution. After gaining independence from England in 1783, the new government found itself in fiscal disarray. Lacking the power to tax under the Articles of Confederation, and unsuccessful in collecting money from the states, the Continental Congress could not fund its expenses. Faced with a postwar recession, the Continental Congress tried to persuade the states to agree to a five percent tariff on foreign trade. Unable to reach consent of the states, and motivated by Shay's Rebellion, the Congress called for a convention in Philadelphia in May 1787 to rework the Articles. Rather than revising the Articles, the Congress wrote a new Constitution granting it the right to collect taxes and tariffs, coin money, raise Armies, provide and maintain a Navy, and, importantly, "To borrow Money on the credit of the United States."[14]

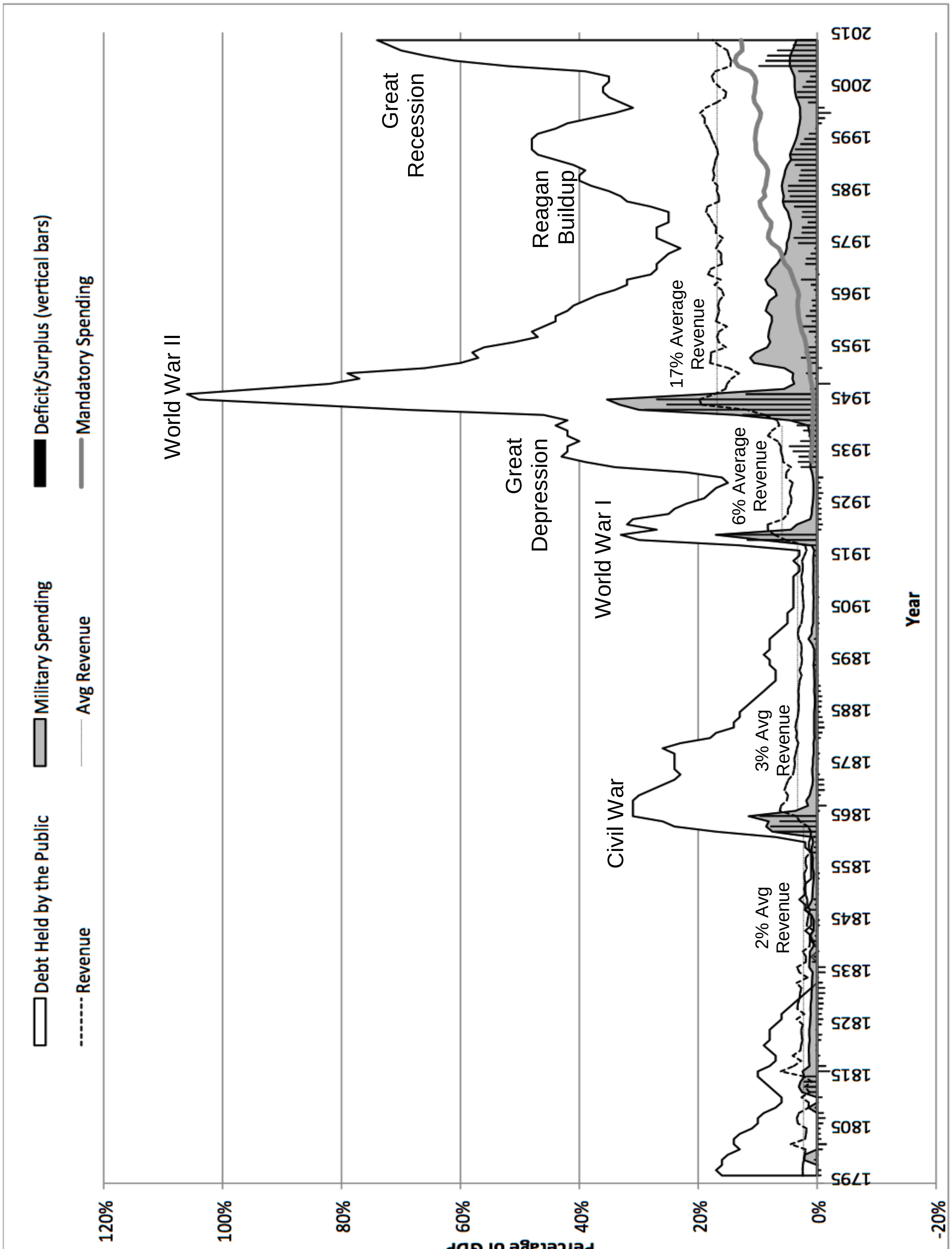

Figure 3. Federal Debt Held by the Public (percentage of Gross Domestic Product)[15]

Alexander Hamilton, having served as General George Washington's aide-de-camp in 1777 at the age of 23, and later as a New York delegate to the Constitutional

Convention, had gained the respect of Robert Morris, “the financier of the Revolution.”[16] In 1781, Hamilton wrote to Morris, recommending the establishment of a national debt. “A national debt, if it is not excessive, will be to us a national blessing. It will be a powerful cement to our union. It will also create a necessity for keeping up taxation to a degree which, without being oppressive, will be a spur to industry.”[17]
Hamilton believed that the national debt could be used to expand the economy by creating a larger, more liquid money supply. He argued that banks could issue loans backed by government bonds, and as long as the government kept up with debt payments, the system would attract investors at home and abroad. At the recommendation of Morris, President George Washington appointed Hamilton as the first Secretary of the Treasury.[18]

Hamilton established several debt management principles still in effect today: the issuance of interest-bearing federal bonds, a system of debt consolidation to manage debt payments, the formation of a federal bank to supplement the Treasury, and, most importantly, the principle of maintaining investor confidence by paying debts when they are due. Hamilton’s program had tremendous success. By 1794, the U.S. held the highest credit rating in Europe and by 1801, Europeans had invested in $33 million of U.S. securities.[19] The new government assumed a total of $80.4 million of debt after the American Revolutionary War, but cut spending and paid the debt down to $45 million by 1811.[20]

The War of 1812

Leading up to the War of 1812, the U.S. learned a couple of tough economic policy lessons. First, after a British frigate fired upon the *USS Chesapeake* in 1807, President Jefferson signed the Embargo Act of 1807. Intended to prevent the British and French from violating U.S. neutrality during the Napoleonic Wars, the act prohibited the export of all goods from the U.S. Jefferson hoped this would avoid the U.S. from becoming involved in war. However, tariff revenues completely collapsed from $17 million in 1808 to $7.7 million in 1809. With decreased revenue came increased debt. Congress repealed the Embargo Act and replaced it with the Non-Intercourse Act, which prohibited trade with just Britain and France. But neither act produced the desired effect. Rather than prevent the seizure of citizens and ships, the acts instilled disdain of the U.S. on the part of Britain and France, both large creditors of U.S. debt.[21]

Second, the U.S. learned a lesson about the need to increase taxes early during a war. Just before the nation returned to war with Britain, Congress raised soldier pay and enlistment bonuses, but did so without raising taxes to pay for the war. Without the needed boost in revenue from taxes, the national debt jumped from $45 million in 1811 to $127 million by the end of the war in 1814. The government funded the war primarily with debt.[22] Following the war, the government again cut spending and worked to pay down the debt.

<u>One Year Without Debt</u>

When President Andrew Jackson took office in 1829, the national debt was roughly $58 million.[23] Jackson had been a land speculator before running for office, and a bad land deal left him deeply in debt. Bitter from that experience, Jackson called banks and the national debt the “national curse” during his campaign for the presidency. While in office, he aggressively sold off public land, closed the national bank, and cut spending in order to pay off the debt. By January 1835, Jackson, with the support of Congress, paid off all interest-bearing federal debt for the first and only time in U.S. history. Over the next year, he divided surplus funds amongst the states. The states in turn printed massive amounts of money to keep up with voracious buyer demand for the sales of public land. In an attempt to slow things down to keep the economy stable, Jackson required gold and silver as payment for all government land sales, except in cases where the purchaser settled on the land. Instead of stabilizing the economy, it caused Wall Street's first crash, known as the "Panic of 1837."[24] The crash resulted in a six-year depression, the longest depression in American history.[25] Still, debt remained low for several years. U.S. public debt rose to $63.1 million during the U.S. war with Mexico, but remained less than 3 percent of GDP.[26] However, the nation, its leadership, and its economy were about to be greatly tested in a war with itself.

The Civil War

The U.S. Civil War presented major economic challenges. The Treasury estimated the direct costs of the war at $5.2 billion.[27] The North and the South faced tough economic policy choices: how much money should they print, how much should they tax, and how much should they borrow? The North printed $450 million and the South printed about $1.5 billion of their own currency. The South paid more than 50 percent of its expenses with their new currency, compared to just 13 percent in the North. Consequently, inflation skyrocketed more than 700 percent over two years in the South compared to about 100 percent inflation over five years in the North. Unable to raise more than six percent of its expenses with taxes, the Confederacy's economy crumbled. The Union raised 21 percent of its revenues through taxes, and most of these were either at higher rates or under completely new taxes, such as the first federal income tax. According to Gordon, "One of the natural principles of taxation, it turns out, is that the people willingly pay very high taxes during wartime."[28] Figure 3 depicts the resultant revenue increase during and after the Civil War, and subsequent increases associated with the First and Second World Wars.

A more significant difference between the North and South, though, was the North's ability to leverage debt in order to resource the war effort and defeat the South. The North's success can be largely attributed to Jay Cooke, a Philadelphia banker who devised the concept of war bonds. Cooke persuaded citizens of all levels of income to buy war bonds, both as a good investment and as a patriotic duty. Cooke's success was instrumental to the North's ability to fund the war. In 1861, President Lincoln, realizing the desperate economic situation and the challenge ahead quipped, "The bottom is out of the tub. What shall I do?"[29] But by May 1864, war bonds were actually covering the Union Army's war costs of $2 million per day and providing two-thirds of the Union's total revenues. Lincoln's ability to leverage debt through Cooke's innovation, in comparison to the Confederacy's inability to do so, was indeed a potent instrument of national policy.[30]

By the war's end, the Union's debt totaled just shy of $2.77 billion with a wide variation of estimates between 31 percent and 50 percent of GDP.[31] Once again, the government worked hard to reduce the debt. Congress affirmed the need to pay the nation's debts with section four of the 14th Amendment: "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."[32]

Despite the expiration of the federal income tax in 1872, the debt steadily declined with only a single minor uptick due to the panic of 1893, until it hovered at 3 percent of GDP before World War I.[33]

World War I

Imports dropped as trade partners in Europe engaged in war. Revenues from the tariff dropped as well. Congress raised taxes in response by reinstating the income tax under the Sixteenth Amendment in 1913. Revenues jumped from $1.1 billion in 1917 to $3.6 billion in 1918. Tariff and excise taxes fell from 90 percent to less than 10 percent of total revenues. Income taxes now provided the bulk of revenues, which has changed little since 1920.[34] Again, there was little resistance to the higher taxes in wartime.[35] The debt peaked in 1919 at 33 percent of GDP.[36]

Following the war, President Warren Harding appointed Andrew Mellon as Treasury Secretary, who would become the most influential person in that position since Alexander Hamilton. Mellon summarized U.S. fiscal policy in his 1924 book, *Taxation: the People's Business:* "Since the war, two guiding principles have dominated the financial policy of the Government. One is the balancing of the budget, and the other is the payment of public debt. Both are in line with fundamental policy of the government since its beginning."[37] In keeping with that policy, which became known as, "pay-as-you-go," the government cut expenditures by 50 percent.[38] Mellon also recommended cutting taxes, which Congress did three times in the early 1920s, in order to grow the economy. Despite reduced tax rates, nominal revenues increased by 3 percent between 1921 and 1926.[39] By 1929, the debt stood at 15 percent of GDP, less than half of what it was ten years earlier and the lowest it has been ever since.[40] But the situation was about to change radically with the Great Depression.

The Great Depression

Following World War I, the U.S. Federal Reserve focused on balancing the need to help Europe rebuild its economy while avoiding speculation on Wall Street. In order to do so, New York Federal Reserve governor Benjamin Strong had to balance these conflicting interests by lowering interest rates to encourage European investment and raising rates to avoid Wall Street speculation. After lowering the rate from 4 percent to 3.5 percent in 1927, speculation grew. Strong raised the rate to 5 percent and restricted money supply in 1928, his last major act before he died of tuberculosis. The rate hike affected the broad economy, but Wall Street continued to bubble. Three policy mistakes would cause a manageable recession to become the Great Depression.

First, lacking Strong's leadership, the Federal Reserve failed to use the tools at its disposal to avoid the crash, such as lowering interest rates or boosting the cash supply. Second, President Hoover increased tariffs in 1930 and other nations followed suit, causing global trade to plummet. As a result, tariff revenues dropped as well. Third, President Hoover raised the income tax rates, which slowed the economy.[41] As a result of these policies, the debt swelled from 15 percent of GDP in 1929 to over 44 percent in 1940.[42] But rather than adhering to the principles of "pay-as-you-go" that Mellon described, President Roosevelt deliberately pushed an unbalanced budget for the first time in the nation's history.[43]

The New Deal and Keynesian Economics

The tax hikes President Hoover approved not only helped spur the Great Depression, but also cost him re-election. President Roosevelt was determined to avoid the same mistakes.[44] By 1933, unemployment peaked at 24.9% and wage income had fallen 42.5% since 1929. Roosevelt responded with his New Deal package that included relief and recovery programs such as the Civilian Conservation Corps, which put unemployed and unskilled young men to work in labor camps; the Tennessee Valley Authority, a massive hydroelectric dam project that still operates today; and Social Security, which would become the largest government program in the United States.[45] However, additional taxes to pay for these programs during a peacetime recession were politically untenable. To that affect, British economist John Maynard Keynes supplied a new approach that fundamentally changed the politician's approach to debt and justified increased government spending.

Keynes published his philosophy, *The General Theory of Employment, Interest, and Money* in 1936. He argued that governments should counter deflation with a mix of lower taxes, increased spending, and increased money supply. He also argued that national debt was irrelevant. "A family, Keynes argued, must necessarily borrow from someone else, but a nation can borrow from itself, the debits and credits canceling each other out, at least macroeconomically, just as a child can borrow from a parent without affecting the family's net worth."[46] Roosevelt partially adopted Keynes' theory in 1937 and expanded deficit spending on even more programs. But it was World War II, not the New Deal or Keynesian economics, that put the nation back to work and ended the Great Depression.[47]

World War II Through the Vietnam War

The Second World War may have put an end to the Great Depression, but it added $211 billion to the federal debt and resulted in the highest ratio of federal debt to GDP in the history of the United States at 106 percent.[48] Together, the Great Depression and the Second World War left the nation with 16 consecutive annual deficits and $241 billion of federal debt.[49]

For the first four years following the war, President Truman cut spending and turned a net surplus of $5.3 billion, allowing him to marginally pay down the debt.[50] Truman used the words “pay-as-we-go” in his January 7, 1953 State of the Union speech to describe his fiscal policy of those four years and his attempts to continue that policy during the Korean War. However, Truman and then Eisenhower also promoted economic welfare and security, continuing the popular entitlement programs that originated from the New Deal, as well as regional economic reconstruction efforts such as the Marshall Plan.[51] Despite the Korean War and the onset of the Cold War, the debt fell a modest $5.02 billion.[52] However, since the economy swelled 135 percent in this timespan, the debt dropped from 106 percent of GDP in 1946 to 44 percent of GDP in 1960.[53]

How did Truman and Eisenhower manage to satisfy the desires to pay down the debt yet continue social programs and fund the Korean War? They heeded the lessons of the Civil War and the First World War: citizens willingly pay taxes during wartime. Truman inherited some of the nation’s highest revenues as a percentage of GDP, which peaked at 19 percent of GDP in 1944 and have averaged 17 percent of GDP in the years since.[54]

The Kennedy and Johnson administrations were the first to fully embrace Keynesian economics. Although spending more than doubled in the 1960’s, the federal debt owned by the public fell from 44 percent to 27 percent of GDP because of economic growth.[55] President Johnson’s attempt to sustain both “guns” for the Vietnam War and “butter” for his Great Society domestic programs led to inflation proved too much for the Keynesian model. Unemployment led to slow growth that lasted through the Nixon, Ford, and Carter administrations. The debt held by the public nominally increased by 150 percent, but as a percentage of GDP it stayed mostly flat between 23 and 27 percent throughout the 1970's.[56]

<u>The Reagan and Bush Years</u>

As President Reagan took office, he inherited the highest levels of inflation in over 30 years and an unemployment rate of 10.8 percent.[57] In order to fight off recession using the concept of supply-side economics, Reagan persuaded Congress to cut taxes.[58] At the same time, he pushed for increased defense spending in an effort to gain a Cold War advantage over the Soviets.[59] However, mandatory spending on entitlements spiraled upward despite Reagan's efforts to slow its growth.

Consider for a moment the contrast from previous peaks of the debt relative to GDP. Reagan leveraged debt as a policy instrument to end the Cold War without employing the use of force. According to Clausewitz's definition of war as, "an act of force to compel our enemy to do our will," Reagan's tenure would not be considered as wartime since the United States and the Soviet Union did not confront each other using force.[60] Accordingly, Reagan's policy of tax cuts in combination with increased government spending during peacetime, mostly outside of recession, juxtaposes the 200-year trend of large deficits only during times of war or in response to a recession.[61] Federal debt jumped from 25 percent of GDP in 1980 to 40 percent in 1988, but it more than doubled in nominal terms.[62] It would grow another five percent as a result of continued deficits under President Bush caused by war in the Middle East and followed by a recession at home before Clinton took office in 1992.

The Last Surplus

In the first four years of the Clinton administration, public debt rose nearly $525 billion, but fell one percent compared to GDP as the economy began to improve. Tightening fiscal policy, Congress raised taxes at the urging of the President. Soon afterwards, a Republican Congress came into power and deficits decreased as both the executive and legislative branches, although opposite political parties, committed themselves to balancing the budget by 2002.[63] In 1998, the government experienced its first budget surplus since 1969, which continued through 2001. Public debt owned by the public dropped 10.2 percent compared to GDP.[64] Unfortunately, the surplus did not last long. Revenues dropped in 2001 as a result of reduced economic growth and large tax reductions. Spending also increased in response to the September 11th terrorist attacks. By 2007, debt held by the public had grown $2.7 trillion since 2001; however, the economy had grown such that the debt compared to GDP had only grown four percent in that same timeframe.[65] With deficits decreasing despite two wars and Hurricane Katrina, the situation appeared to be improving in 2007 until the onset of a recession in December 2007 and a financial crisis in 2008.[66]

The Great Recession

Based on signs of a looming recession in December 2007, President Bush signed the Economic Stimulus Act of 2008 with the hope of increasing consumer spending. However, it was largely unsuccessful.[67] By September 2008, risky practices in private-sector mortgage and financial markets led to a financial crisis that deepened the recession. In addition to automatic increases in unemployment assistance, the government increased outlays and reduced taxes, further attempting to stimulate the economy. Deficits climbed and the debt soared from 35.2 percent of GDP in 2007 to 74.1 percent in 2014.[68]

Meanwhile, the surges in Iraq and Afghanistan added to the deficits. However, defense spending as a percentage of GDP remained under 5 percent, peaking at 4.7 percent in 2009 and averaging 3.9 percent of GDP from 2001 through 2014.[69] In comparison, defense spending exceeded five percent of GDP in 60 out of the last 100 years.[70] In contrast, mandatory spending for Social Security, Medicare, Medicaid, and Welfare averaged 13.5 percent of GDP from 2001 to 2014.[71] In other words, defense spending during the wars in Afghanistan and Iraq (3.9 percent of GDP on average) contributed to the growth of the federal debt, but it was just over one-fourth the cost of mandatory spending.

There is another less-discussed aspect of federal debt that is often overlooked, but important to understand in terms of the Great Recession. The government borrows money each year to cover the deficit, but it also accounts for financial assets (loans from the government to other entities, such as student loans) as part of the debt. For this reason, there is a difference between the deficit and the annual increase in the debt each year.[72]

One part of financial assets not accounted for by the deficit calculation is the Troubled Asset Relief Program (TARP). The government created TARP in response to the Great Recession in order to bail out the automobile, bank investment, and credit industries; the housing market; and American International Group (AIG).[73] The government invested $427.1 billion into TARP mostly during fiscal year 2009, which, combined with the $1.413 trillion deficit, helps explain the dramatic spike in the national debt that year.[74]

Projections of the Federal Debt

Numerous projections of the federal debt are available to the public. The CBO published at least five projections in the first three months of 2015 based on current fiscal policy, modifications to that policy, or proposals from the President, the House, or the Senate Budget Committee chairs. These projections are summarized in Figure 4.[75]

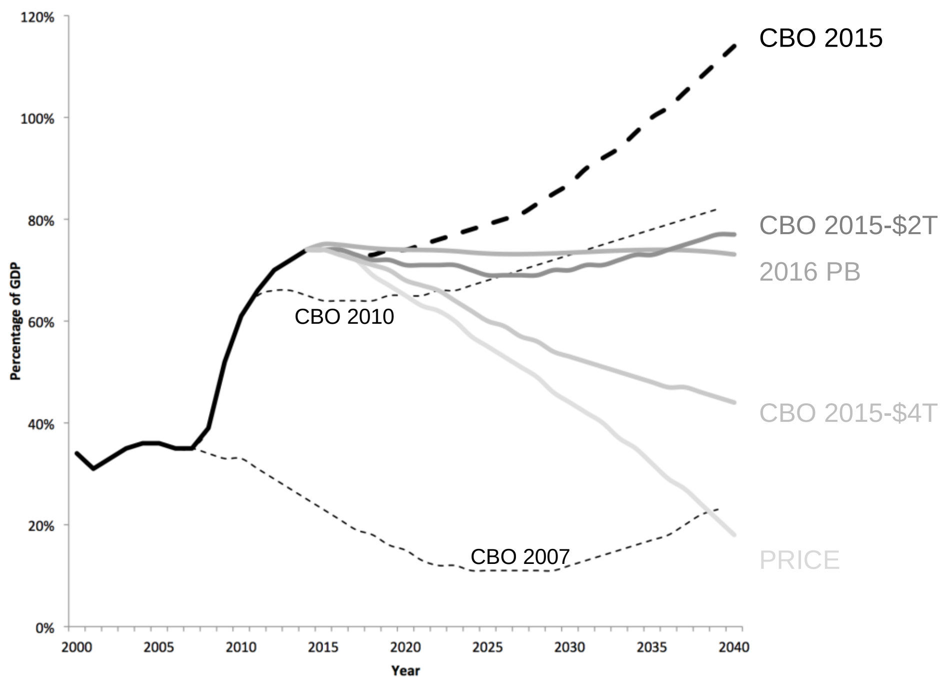

Figure 4. Projections of Federal Debt Held by the Public[76]

Some common themes emerge from the projections. First, the most important notion to recognize in these debt projections is they carry a wide level of uncertainty. There are multiple variables for which each projection makes assumptions, such as interest rates, inflation (or deflation), GDP, demographics, war, recessions, and other unforeseen crises. For example, the President's Fiscal Year 2016 Budget's uncertainty for debt 2040 ranges from 70 percent of GDP to 141 percent of GDP.[77] Second, mandatory spending, especially on health care, greatly impacts the projections. The President's budget claims that lower projected health care costs will yield progress in lowering the debt.[78] The CBO's 2015 baseline projected rising deficits after 2018, citing increasing health care costs as much as 7 percent per year.[79] The 2015 baseline exceeds the level of the Second World War, but what does that mean to national security?

Debt as a National Security Risk

Several strategic leaders have appreciated the relationship between economics and national security since the founding of the United States of America. Alexander Hamilton urged President George Washington to "cherish credit as a means of strength and security."[80] Modern strategic leaders also recognize this critical relationship between economics and security. Former Chairman of the Joint Chiefs of Staff, Admiral Michael Mullen, described the U.S. debt burden as the "single biggest threat" to national security and said that its enemies had taken note.[81] The potential risk to national security becomes more stirring when potential adversaries, like former Iranian President Mahmoud Ahmadinejad, ask, "How long can a government with a $16 trillion foreign debt remain a world power?"[82]

Excessive debt increases risk to national security because excessive debt can negatively impact the health of the economy. Economic power plays several important roles in relation to national security. First, it provides funding for military force structure, materiel, and readiness. Second, the economy serves as a provider of economic security through stable sources of profits and income in order to support a comfortable standard of living. Third, the economy influences interaction between states in the form of trade and investments, which can result in interdependencies or competing interests.[83] Finally, statesmen use economic tools such as sanctions, export controls, tariffs, and financial incentives to wield influence and advance national interests. Thus, a strong economy is a necessary prerequisite for national security. As Joseph Nye put it, "military force has been called 'the ultimate form of power' in world politics, but a thriving economy is necessary to produce such power."[84] Former Secretary of State Hillary Clinton also remarked, "[the economy] underwrites all the elements of smart power: robust diplomacy and development and the strongest military the world has ever seen."[85]

Impact of Debt on Economic Power

Periods of deficits during and after an economic recession can benefit the economy and accelerate recovery after a recession. Increased government spending can stimulate the economy by boosting demand for goods and services, increasing private industry output, and bringing the unemployed back into the workplace. But prolonged deficits that lead to excessive debt create unhealthy consequences for the economy in the long term. One consequence is that debt generally causes a reduction in domestic earning because increased federal borrowing draws money away from (or "crowds out") private investment in productive capital. CBO estimates that for each dollar that deficits rise, domestic investments fall by a range of 15 to 50 cents.[86]

Increased debt also leads to increased interest that the government must pay to lenders. This further increases debt if not offset by either increased taxes or cuts to government spending. Higher taxes typically discourage work and saving, which negatively impacts economic health. Cuts to government spending can also lower demands for goods and services, limiting economic growth.[87]

A high level of debt also limits options for policymakers to respond to crises, such as recessions, banking crises, and wars. Low levels of debt leave more room allowing policymakers to borrow in order to increase government spending and reduce taxes in order to stimulate the economy. But governments with high levels of debt may be less likely to continue borrowing as investors lose confidence.[88] Alternatively, investors may demand higher interest rates, increasing the cost of borrowing and further increasing the debt.[89] The CBO projects that interest payments on the federal debt will exceed the entire defense budget by 2023.[90]

Debt affects the characteristics of economic power, such as size and quality of the economy, investments, production, trade, and competition. But economic power also affects diplomatic, information, and military power. Appropriately, the 2015 National Security Strategy acknowledges that the economy underwrites both the military and diplomatic instruments of power and creates opportunity to advance national security.[91]

Recommendations

Although economists and security professional generally agree that excessive levels of debt can pose risks to the economy and national security, there is little consensus on what thresholds of debt might pose certain levels of risk. To keep within the scope of this paper, the following recommendations avoid policy options to achieve a particular goal for debt compared to GDP but offer broad recommendations to help shape policymakers' decisions.

First, with the economic outlook improving, Congress should eliminate or postpone automatic sequestration cuts and find ways to slow or freeze mandatory spending. In our nation's 239-year history, we have dealt with threats more existential than what the national debt appears to pose right now. A steady course of action rather than abrupt sequestration cuts will expose the economy to lower risk while attempting to meet the long-term needs of the nation. James Galbraith summarizes, “Since 1960, three times our leaders have tried to balance the budget and so reduce the debt. Each time, in 1969, 1980, and again in 2000, guess what happened? Recession. Because running a budget surplus means draining funds from private businesses and families. … It just isn't smart.”[92] Additionally, sequestration presents policymakers with a false choice between deficits and defense since it does not affect the mandatory entitlements that make up two-thirds of all government spending.[93] From a historical perspective, there are only two times in our history when the deficit significantly exceeded defense spending: the Great Depression and the Great Recession (see Figure 3; the vertical bars exceed the shaded “Military Spending” area in those time periods). This indicates that the current debt situation is less about defense spending and more about mandatory spending on entitlements.

Second, the Department of Defense should consider changing its narrative regarding sequestration. Rather than focus on the military-oriented threats of sequestration, which have been abundantly addressed in posture statements and the Quadrennial Defense Review, the Department should instead focus on shared interests. The security risks are important but, unfortunately, difficult to translate to a monetary value discussion. Galbraith’s tie of past attempts to balance budgets with recession translates easily, but would sequestration cause a recession? An interesting coincidence is that annual real GDP growth during 4Q2013 (the second quarter sequestration was in effect) slowed by one percent, but then plummeted from 3.5 percent growth to negative 2.1 percent (contraction) in 1Q2014. In 2Q2014, after

Congress passed the 2013 Bipartisan Budget Agreement, annual real GDP growth jumped to 4.6 percent.[94] There is not enough data to prove causality, but it is possible that sequestration and the related government shutdown, both relatively short in duration, exposed the nation to economic risk. Was it worth it? The annual cuts due to sequestration would have been $109.3 billion in 2014.[95] Had sequestration continued in 2014 with real GDP growth at negative 2.1 percent, the reduction in revenue would have been approximately $65.1 billion for fiscal year 2014.[96] That makes the net cut just $44.2 billion for fiscal year 2014 with the added risks of a possible recession and reduced military readiness.

Third, the President's Council of Economic Advisors should establish and maintain a long-range National Economic Strategy, similar to existing national-level strategies such as the National Military Strategy. Nested under the National Security Strategy, the National Economic Strategy would be utilized to support, shape, and defend national policies regarding the economy, such as the debt, trade, and the Rebalance to the Pacific. It should provide a description of the strategic economic environment and identify opportunities and challenges, such as how the public and private sector can work together to expand the use of economic power in the Asia-Pacific region.

The fourth recommendation is to create a Chief Economist position in the Department of Defense. The Chief Economist, similar to the Chief Economist in the Department of State, would directly advise the Secretary of Defense and Chairman of the Joint Chiefs on issues affecting the interactions of the Department with Wall Street, the U.S. Federal Reserve Bank, foreign investment markets, and foreign central banks.

The Chief economist would also advise the Secretary and Chairman on ways to create synergy in the use of economic power with the other instruments of national power. The Chief Economist would also advise the Secretary and Chairman on strategic communications with Congress, the American public, and the international community.[97]

A final recommendation is to change the federal accounting practice to include federal liabilities such as TARP in the deficit. It costs little more than administrative work to implement this recommendation and doing so would enhance transparency when comparing deficits to debt. More importantly, it would provide clarity to stakeholders, such as Congress and the U.S. taxpayer.

Conclusion

The outlook on the national debt appears to be improving as the economy continues to rebound from the Great Recession. The CBO's analysis of the President's 2016 budget proposal makes no mention of debt as "unsustainable," as had been done in its 2014 and 2015 outlooks. The House Budget Committee's budget resolution proposal also appears to put the national debt on a more sustainable path. But many political decisions remain before either proposal or a compromise proposal becomes law. Recalling the lessons of our nation's rich history and understanding the relationship between the economy, debt, and security will help shape these decisions to the benefit of the nation and its future.

Endnotes

[1] Congressional Budget Office, *The 2014 Long-Term Budget Outlook* (Washington, DC: U.S. Government Printing Office, July 2014), 9, http://www.cbo.gov/publication/45471 (accessed February 5, 2015).

[2] Barack H. Obama, *National Security Strategy* (Washington DC: The White House, May 2010), 10.

[3] Congressional Budget Office, *The 2014 Long-Term Budget Outlook*, 9.

[4] U.S. Department of Treasury, *Historical Debt Outstanding, Annual 2000 to 2014* (Washington DC: U.S. Department of Treasury, December 31, 2014), http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm (accessed February 2, 2015); U.S. Department of Treasury, *Monthly Statement of the Public Debt of the United States: December 31, 2014* (Washington DC: U.S. Department of Treasury, December 31, 2014), 1, http://www.treasurydirect.gov/govt/reports/pd/mspd/2014/2014_dec.htm (accessed February 2, 2015).

[5] Barack H. Obama, "Remarks by the President in State of the Union Address," public speech, Washington DC, January 20, 2015, http://www.whitehouse.gov/the-press-office/2015/01/20/remarks-president-state-union-address-january-20-2015 (accessed February 3, 2015).

[6] John S. Gordon, *Hamilton's Blessing: The Extraordinary Life and Times of Our National Debt* (New York: Walker's Publishing Company, 1997), 3.

[7] "Debt held by the public" consists of securities issued to raise funds to pay for federal government spending. "Debt held by government accounts" is debt issued internally by the government between trust funds and other federal accounts (e.g., transfers from a surplus in the Social Security fund to cover a portion of discretionary spending). Congressional Budget Office, *Glossary* (Washington DC: U.S. Government Printing Office, January 2012), 6, http://www.cbo.gov/sites/default/files/glossary_0.pdf (accessed January 16, 2014).

[8] U.S. Department of Treasury, *Monthly Statement of the Public Debt of the United States: December 31, 2014*, 1.

[9] Figures adapted based on the debt as of December 31, 2014. Gregory Gwyn-Williams, Jr., "National Debt Stacked in Dollar Bills Would Stretch from Earth to Moon Five Times," January 26, 2013, http://cnsnews.com/mrctv-blog/gregory-gwyn-williams-jr/national-debt-stacked-dollar-bills-would-stretch-earth-moon-five (accessed February 21, 2015).

[10] Christopher Chantril, "Gross Public Debt, U.S. From FY1900 to FY2014," http://www.usgovernmentdebt.us/spending_chart_1900_2014USb_16s2li0181200_800cs_H0f (accessed February 21, 2015).

[11] Christopher Chantril, "Real Gross Domestic Product History, U.S. From FY1900 to FY2014," http://www.usgovernmentrevenue.com/revenue_chart_1900_2014USb_16s1li0181200_600cs__US_Real_Gross_Domestic_Product_History (accessed February 21, 2015).

[12] Unless listed otherwise, use of the term "debt" refers to "debt held by the public" in this paper. Figures listed for either GNP or GDP prior to 1929 are estimates calculated by economic historians. From 1929 to 1991, the Commerce Department reported Gross National Product (GNP). The United States began reporting GDP in 1991 instead of GNP because most other countries were reporting GDP. Gordon, *Hamilton's Blessing,* 42.

[13] Congressional Budget Office, *The Budget and Economic Outlook: 2015 to 2025* (Washington DC: U.S. Government Printing Office, January 2015), 19,

http://www.cbo.gov/sites/default/files/cbofiles/attachments/49892-Outlook2015.pdf (accessed February 21, 2015).

[14] U.S. Constitution, art. 1, sec. 8; Congress's power to borrow money is one of the few Constitutional powers granted to one branch of government without checks and balances from the others. Gordon, *Hamilton's Blessing*, 16.

[15] Compiled based on data retrieved from Christoper Chantril, "Accumulated Gross Federal Debt," http://www.usgovernmentdebt.us/spending_chart_1792_2020USp_16s1li001mcn_H0f00f30f40t_Accumulated_Gross_Federal_Debt (accessed February 20, 2015).

[16] Ibid., 19.

[17] Ibid., 20.

[18] Ibid., 27.

[19] Ibid., 39.

[20] John S. Gordon, "A Short History of Debt," *American History* 46, no. 4 (October 2011): 60.

[21] Ibid., 45.

[22] The Treasury sold $69 million of bonds. Ibid., 60.

[23] Ibid.

[24] Ibid.," 61.

[25] Robert Smith, "When the U.S. Paid Off the Entire National Debt (and Why it Didn't Last)," April 15, 2011, *National Public Radio*, audio file, http://www.npr.org/templates/transcript/transcript.php?storyId=135423586 (accessed March 4, 2015).

[26] U.S. Treasury, "Historical Debt Outstanding: The 19th Century."

[27] Ibid.

[28] Gordon, *Hamilton's Blessing*, 76.

[29] Ibid., 70.

[30] Ibid., 79.

[31] Ibid., 80; Congressional Budget Office, "July 2014 Release" *from the 2014 Long-Term Budget Outlook* (Washington DC: U.S. Government Printing Office, July 25, 2014), http://www.cbo.gov/sites/default/files/cbofiles/attachments/45308-2014-07-LTBOSuppData_update2.xlsx (accessed March 5, 2015).

[32] The remainder of section four of the 14th Amendment continues, "But neither the United States nor any state shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slave; but all such debts, obligations and claims shall be held illegal and void." U.S. Constitution, amend. 14, sec. 4.

[33] Congressional Budget Office, "July 2014 Release."

[34] The First World War marked a dramatic and enduring shift in federal spending and revenues. Before the war, annual federal expenditures exceeded the $1 billion mark only once in 1863. Since 1917, annual federal expenditures have never been less than $2.9 billion. Gordon, *Hamilton's Blessing*, 103.

[35] Ibid., 104.

[36] Congressional Budget Office, "July 2014 Release."

[37] Gordon, *Hamilton's Blessing*, 103.

[38] Ibid., 110.

[39] Ibid., 111.

[40] Congressional Budget Office, "July 2014 Release."

[41] Gordon, *Hamilton's Blessing*, 118.

[42] Congressional Budget Office, "July 2014 Release."

[43] Gordon, *Hamilton's Blessing*, 122.

[44] President Roosevelt came into office with a "pay-as-you-go" fiscal policy philosophy. During his campaign, his criticized President Hoover in a radio address, saying, "Let us have the courage to stop borrowing to meet continuing deficits. Any government, like any family, can, for a year, spend a little more than it earns. But you know and I know that a continuation of that habit means the poorhouse." However, after arriving in office, his economic advisors recommended he tolerate "passive deficits," which derive from unplanned and insufficient revenues rather than planned increases in spending. President Roosevelt and his advisors considered this preferable to raising taxes, which failed President Hoover. Gordon, *Hamilton's Blessing*, 122.

[45] Franklin D. Roosevelt Presidential Library and Museum, "The Great Depression," http://www.fdrlibrary.marist.edu/facts.html#depression (accessed March 17, 2015).

[46] Gordon, *Hamilton's Blessing*, 131.

[47] Franklin D. Roosevelt Presidential Library and Museum, "The Great Depression".

[48] Gordon, *Hamilton's Blessing*, 129.

[49] U.S. Office of Management and Budget, "Historical Table 7.1 – Federal Debt at the End of the Year: 1940 - 2020," *Historical Tables* (Washington, DC: U.S. Government Printing Office, February 2015), https://www.whitehouse.gov/omb/budget/Historicals (accessed March 17, 2015).

[50] This number differs from Truman's 1953 State of the Union address, in which he stated the net surplus as $4.3 billion. Harry S. Truman, "Annual Message to the Congress on the State of the Union," (Washington, DC: The White House, January 7, 1953), http://www.presidency.ucsb.edu/ws/index.php?pid=14379#axzz1krP0zI00 (accessed March 17, 2015); U.S. Office of Management and Budget, "Historical Table 1.2 – Summary of Receipts, Outlays, and Surpluses or Deficits as Percentages of GDP: 1930-2020," *Historical Tables,* (Washington, DC: U.S. Government Printing Office, February 2015), https://www.whitehouse.gov/omb/budget/Historicals (accessed March 17, 2015).

[51] Harry S. Truman, "Annual Message to the Congress on the State of the Union."

[52] U.S. Office of Management and Budget, "Historical Table 7.1."

[53] Calculated from U.S. Department, *Table 1.1.5, Gross Domestic Product*, http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1 - reqid=9&step=3&isuri=1&904=1960&903=5&906=a&905=1946&910=x&911=0 (accessed March 17, 2015); U.S. Office of Management and Budget, "Historical Table 7.1."

[54] Calculated from U.S. Office of Management and Budget, "Historical Table 1.2."

[55] U.S. Office of Management and Budget, "Historical Table 7.1."

[56] Ibid*.*

[57] U.S. Inflation Calculator, http://www.usinflationcalculator.com/inflation/historical-inflation-rates/ (accessed March 19, 2015); Gordon, "A Short History of Debt," 60.

[58] Supply-side economics "emphasizes economic growth achieved by tax and fiscal policy that creates incentives to produce goods and services." Laffer Center, "Supply-Side Economics," March 10, 2011, http://www.laffercenter.com/supply-side-economics/ (accessed March 19, 2015).

[59] Reagan explained his reprioritization in the 1982 State of the Union address: "Where Government had passively tolerated the swift, continuous growth of automatic entitlements and had actively shortchanged the national security, a long-overdue reordering of priorities has begun, entitlement growth is being checked, and the restoration of our defenses is underway." Ronald Reagan, "Message to the Congress Transmitting the Fiscal Year 1983 Budget," (Washington, DC: The White House, February 8, 1982), http://www.presidency.ucsb.edu/ws/index.php?pid=41977&st=defense&st1= - ixzz1lSrYqjYL (accessed March 18, 2015).

[60] Carl von Clausewitz, *On War*, eds. and trans. Michael Howard and Peter Paret (Princeton, NJ: Princeton University Press, 1976), 75.

[61] The National Bureau of Economic Research Reagan identified the periods from January 1980 to July 1980 and July 1981 to November 1982 as the only recessions during the 1980's. National Bureau of Economic Research, "U.S. Business Cycle Expansions and Contractions," April 23, 2012, http://www.nber.org/cycles/US_Business_Cycle_Expansions_and_Contractions_20120423.pdf (accessed March 19, 2015); U.S. Office of Management and Budget, "Introduction to the Historical Tables: Structure, Coverage, and Concepts," *Historical Tables* (Washington, DC: U.S. Government Printing Office, February 2015), 6, https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/hist_intro.pdf (accessed March 17, 2015).

[62] U.S. Office of Management and Budget, "Historical Table 7.1."

[63] Gordon, *Hamilton's Blessing*, 172.

[64] Calculated from U.S. Office of Management and Budget, "Historical Table 7.1."

[65] Ibid*.*

[66] U.S. Office of Management and Budget, "Introduction to the Historical Tables," 7.

[67] The Act provided a total of $152 billion in tax rebates to 130 million households. Eighty percent of the households surveyed by the University of Michigan indicated they would use the rebates to save (31.8 percent) or pay off debt (48.2 percent) rather than increase spending. This may have been the first sign of a different type of financial crisis, one rooted in household debt rather than one resulting from the changes to fiscal and monetary policy. It highlighted the importance of correctly diagnosing the reasons for recession before applying a policy to correct it. Matthew D. Shapiro and Joel B. Slemrod, *Did the 2008 Tax Rebates Stimulate Spending?* (Cambridge, MA: National Bureau of Economic Research, February 2009), 3, http://www.nber.org/papers/w14753.pdf (accessed March 20, 2015).

[68] U.S. Office of Management and Budget, "Historical Table 7.1."

[69] U.S. Office of Management and Budget, "Historical Table 3.1 – Outlays by Superfunction and Function: 1940 - 2020," *Historical Tables* (Washington, DC: U.S. Government Printing Office, February 2015), https://www.whitehouse.gov/omb/budget/Historicals (accessed March 17, 2015).

[70] During previous wars in the last 100 years, defense spending compared to GDP peaked at 37 percent during the Second World War, 13.8 percent during the Korean War, 9.1 percent in the Vietnam War, and 5.1 percent in the Gulf War. Christopher Chantril, "Defense Spending Chart, U.S. From FY1915 to FY2014," http://www.usgovernmentspending.com/spending_chart_1915_2014USp_16s2li011mcn_30f_Defense_Spending_Chart (accessed February 21, 2015).

[71] U.S. Office of Management and Budget, "Historical Table 3.1."

[72] For example, the 2016 budget summary table S-13 shows the 2014 deficit as $485 billion. The table also shows $313 billion of changes in financial assets and liabilities, $278 billion of changes in debt held by government accounts, and $7 billion due to other factors.

Combined, the total change in gross national debt was $1.082 trillion ($597 billion more than the deficit). Stan Collender, "There Is No Budget Conspiracy: Why Federal Debt Increases By More Than The Deficit," *Forbes,* November 4, 2014, http://www.forbes.com/sites/stancollender/2014/11/04/there-is-no-budget-conspiracy-why-federal-debt-increases-by-more-than-the-deficit/2/ (accessed March 19, 2015); U.S. Office of Management and Budget, *The Budget for Fiscal Year 2016: Summary Tables* (Washington, DC: U.S. Government Printing Office, February 2, 2015), https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/budget.pdf (accessed March 17, 2015).

[73] U.S. Department of the Treasury, "About TARP: What did TARP Do?" http://www.treasury.gov/initiatives/financial-stability/about-tarp/Pages/what-did-tarp-do.aspx (accessed March 19, 2015).

[74] U.S. Department of Treasury, "TARP Tracker from October 2008 to Date," http://www.treasury.gov/initiatives/financial-stability/reports/Pages/TARP-Tracker.aspx (accessed March 20, 2015); U.S. Office of Management and Budget, *The Budget for Fiscal Year 2011* (Washington, DC: U.S. Government Printing Office, February 2, 2015), 178, http://www.gpo.gov/fdsys/pkg/BUDGET-2011-BUD/pdf/BUDGET-2011-BUD.pdf (accessed March 17, 2015).

[75] The "CBO 2015" projection represents the CBO's 2015 baseline prediction of the debt based on current law, while "CBO 2010" and "CBO 2007" represent projections made by the CBO in those years. The "CBO 2015-$2T" and "CBO 2015-$4T" projections represent the CBO's estimates of $2 trillion or $4 trillion deficit reductions applied to the CBO's 2015 baseline prediction over ten years, then continued through 2040. These do not provide adjustment for interest savings and other economic effects. All of these projections assume automatic sequestration cuts in 2016, so a repeal of sequestration under current budget policy would make these projections higher. The "PRICE" projection represents the House Budget Committee's 2016 budget proposal. Congressional Budget Office, *Budgetary and Economic Outcomes Under Paths for Federal Revenues and Noninterest Spending Specified by Chairman Price* (Washington, DC: U.S. Government Printing Office, March 17, 2015), 3, http://www.cbo.gov/sites/default/files/cbofiles/attachments/49977-PriceBudgetResolution.pdf (accessed March 19, 2015).

[76] Congressional Budget Office, "Data Underlying Figures and Supplemental Data," March 17, 2015, http://www.cbo.gov/sites/default/files/cbofiles/attachments/49977-Price_Additional_Data-2.xlsx (accessed March 19, 2015); Congressional Budget Office, "CBO's Projections for the President's Budget," (Washington, DC: U.S. Government Printing Office, March 12, 2015), http://www.cbo.gov/sites/default/files/cbofiles/attachments/50021-APB_SupplementalData-2.xlsx (accessed March 19, 2015).

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https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/spec.pdf (accessed March 17, 2015).

[79] Congressional Budget Office, *The Budget and Economic Outlook*, 67.

[80] Robert B. Zoellick , "American Exceptionalism: Time for New Thinking on Economics and Security," Alastair Buchan Memorial Lecture, IISS, London, July 25, 2012, quoted in Alexander Ferguson, "The Uneasy Relationship between Economics and Security," *PRISM* 4, no. 2 (2013): 78.

[81] Alexander Ferguson, "The Uneasy Relationship between Economics and Security," *PRISM* 4, no. 2 (2013): 78.

[82] "Iran: How long can Debt-Laden U.S. Remain World Power?" *Jerusalem Post,* October 18, 2012, quoted in Alexander Ferguson, "The Uneasy Relationship Between Economics and Security," *PRISM* 4, no. 2 (2013): 78.

[83] Dick K. Nanto, *Economics and National Security: Issues and Implications for U.S. Policy* (Washington DC: U.S. Library of Congress, Congressional Research Service, January 4, 2011), 5, http://fas.org/sgp/crs/natsec/R41589.pdf (accessed February 20, 2015).

[84] Joseph S. Nye, Jr., *The Future of Power* (New York: Public Affairs, 2011), 52.

[85] U.S. Secretary of State Hillary R. Clinton, "Economic Statecraft," public speech, Economic Club of New York, New York City, October 14, 2011, http://www.state.gov/secretary/20092013clinton/rm/2011/10/175552.htm (accessed on February 16, 2015).

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[88] Ibid, 4.

[89] When Interest rates on government debt increase, the percentage of debt also increases. Congressional Budget Office, *The 2014 Long-Term Budget Outlook*, 89.

[90] Congressional Budget Office, *The Budget and Economic Outlook: 2015 to 2025*, 60.

[91] Barack H. Obama, *National Security Strategy* (Washington DC: The White House, February 2015), 15.

[92] The quotation is in response to his question, "Since 1960, three times our leaders have tried to balance the budget and so reduce the debt. Each time, in 1969, 1980, and again in 2000, guess what happened? Recession. Why?" James Galbraith, "Why We Don't Need to Pay down the National Debt," September 21, 2010, http://www.theatlantic.com/business/archive/2010/09/why-we-dont-need-to-pay-down-the-national-debt/63273/ (accessed March 19, 2015).

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[95] Richard Kogan, *Sequestration by the Numbers* (Washington DC: Center on Budget and Policy Priorities, March 22, 2013), 12, http://www.cbpp.org/files/3-22-13bud.pdf (accessed on March 24, 2015).

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