

Osher Lifelong Learning Institute, Summer 2025

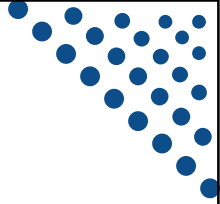
The Economics of Public Policy Issues

Northwestern University

Host: Geoffrey Woglom
Director, National Economic Education Delegation

Available NEED Topics Include:

- US Economy
- Healthcare Economics
- Climate Change
- Economic Inequality
- Economic Mobility
- Trade and Globalization
- Minimum Wages
- Immigration Economics
- Housing Policy
- Federal Budgets
- Federal Debt
- Black-White Wealth Gap
- Autonomous Vehicles
- US Social Policy



Outline

- **Definitions, Basic Data and Historical Data.**
- **Traditional Economic Analysis of the Costs of the Debt**
- **Recent Congressional Budget Office (CBO) analysis of the Cost of the Debt.**
- **Debt, Trade Deficits and “Our Exorbitant Privilege”**
- **Citizen’s Guide to Budget Reconciliation.**



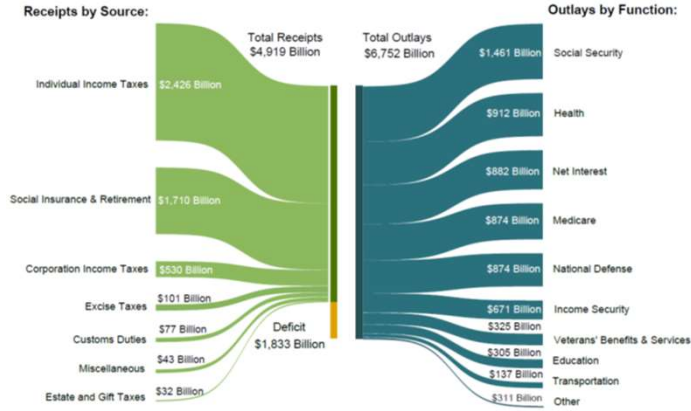
Basic Definitions

- **Fiscal year Deficit = Total Outlays Less Revenues between Oct to September.**
- **The deficit is paid for by government borrowing: (net) issue of new government bonds.**
 - In 2024, the government issued \$28.5 trillion in new Treasuries (<https://treasurydirect.gov/auctions/>) to finance a \$2 trillion deficit.
- **The accumulated value of past borrowing is the total government debt.**



The Federal Budget in FY2024 (ended 9/30)

Inc Tax, 49%
SS Tax, 35%
Corp Tax, 11%



Mandatory: \$4.1tr, 61%
Discretion.: \$1.8tr, 27%
Net Interest, \$0.9tr, 13%

Deficit: 1.8 tr, 25%
6.4% of GDP

Programmatic Outlays = Mandatory + Discretionary



Source: Monthly Treasury Report, 9/2024

Where Do the Federal Dollars Come from?



Inc Tax, 49%
SS+Medicare Tax, 35%
Corp Tax, 10%



Where Do Federal Dollars Go?



Source: BofA Global Investment Strategy, Congressional Budget Office.

BofA GLOBAL RESEARCH

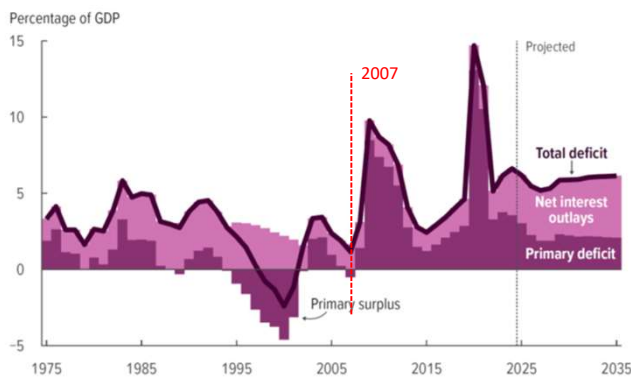
Programmatic Outlays = Mandatory + Discretionary

Paul Krugman, "The Federal government is basically an insurance company with an Army."
 $1.8+1.5+0.4+0.2+0.9= 4.8$; $4.8/5.9=0.81=81\%$



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Past and Future of Deficits



Useful Deficit Decompositions:

Total **Deficit**=
Primary Deficit + Net Interest,

Primary Deficit =
Programmatic Outlays less Taxes

E.g., 2007: $1.1 = (17.4+1.7) - 18.0 = 1.1$
 $1.1 = (17.4-18.0)+1.7 = 1.1$

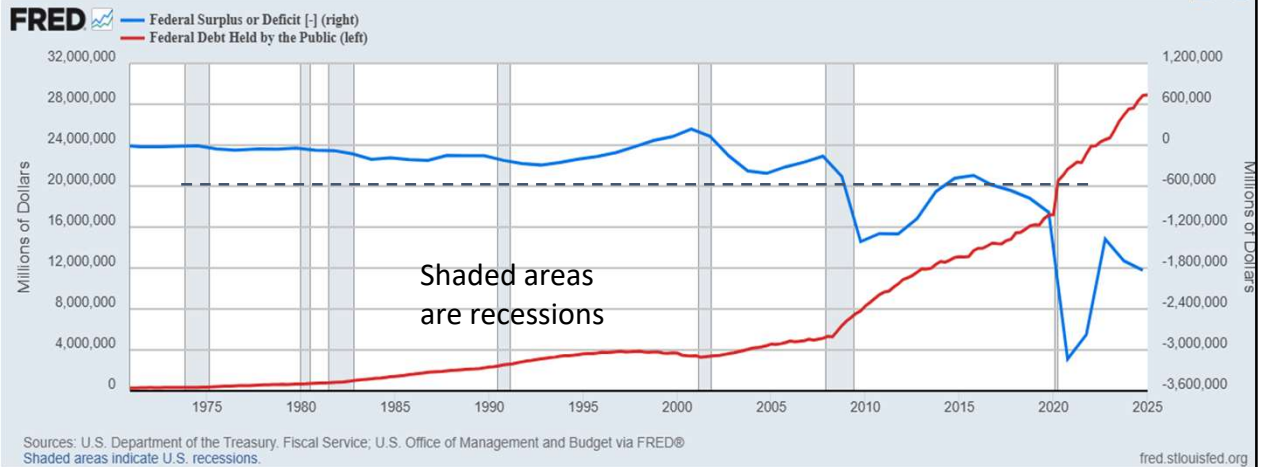
Policies aimed at reducing Debt and Deficit must focus on the primary deficit



CBO, "The Budget and Economic Outlook," Jan 2025

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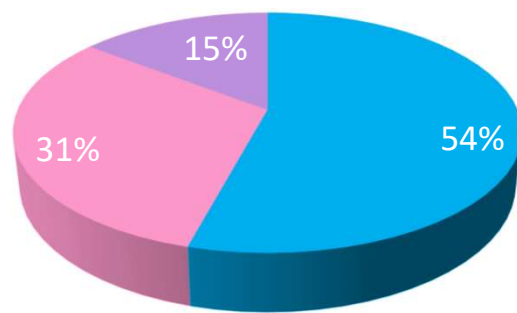
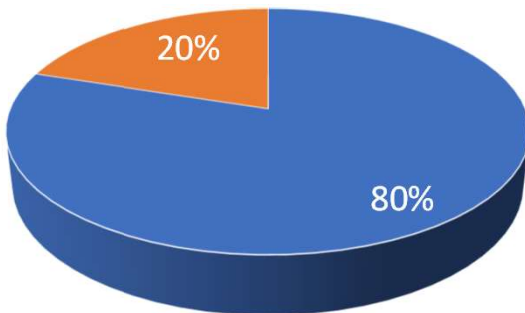
Debt vs. Deficit



A Breakdown of the Total Federal Debt

Total Public Debt: \$36.2 tr, 5/31

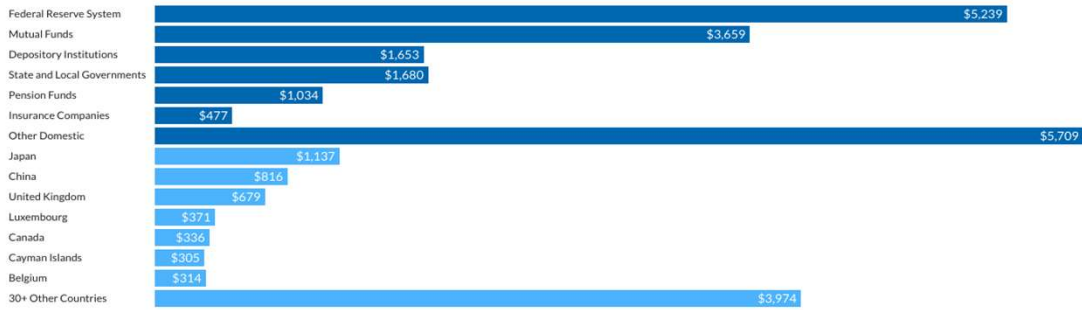
Publicly Held Debt: \$28.6 tr, 5/31



Ownership of \$27 trillion Publicly Held Debt (12/23)

Two-thirds of public debt is held by domestic holders

Composition of Debt Held by the Public (Billions of \$)



US Savings Bonds, \$120 billion



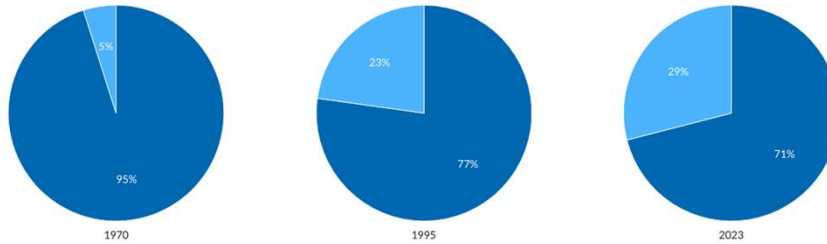
Source: U.S. Department of the Treasury



The Growing Importance of Foreign Held Debt

U.S. dependency on foreign lenders to finance the federal debt has risen over the last few decades

■ Domestic ■ Foreign



Sources: Office of Management and Budget and U.S. Department of the Treasury
Note: Data reflect debt held by the public at the end of the fiscal year.



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Not All Debt Is Created Equal

Intra-governmental debt is important bookkeeping.

- This debt **DOES NOT** require funding on credit markets

- **Debt held by the public**

- This debt is funded by borrowing on credit markets and competes with private funding.

- **Most analyses focus on the publicly held debt *relative* to GDP because:**

- To the extent that debt and deficits have burdens these burdens depend on the size of the debt *relative* to the size of the economy.



CBO: Budget Analysts in Chief

- **The Congressional Budget Office was founded in 1974 to provide Congress with information about the budgetary implications of legislation.**

- **Two kinds of Reports**

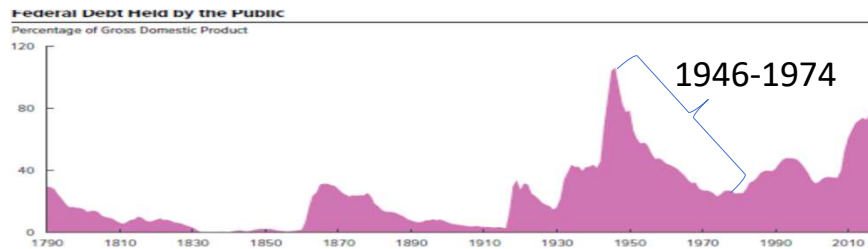
- Cost Estimates or “Scoring”
 - o H.R. 5409, Safeguarding American Farms from Foreign Influence Act
 - o Build Back Better Scoring.

- **Projections of Debt and Deficits – The Budget and Economic Outlook: 2025 to 2035,**

- <https://www.cbo.gov/publication/60870>



Key Points About the U.S. Relative Debt



1. Relative debt peaked during WWII (106%) - followed by a steady decline until the 1980s.
2. Prior to 1983, relative debt rose *purposefully* (wars, recessions, public investment) and then fell.
3. What can we learn from the 46-74 period, where the relative debt fell continuously?



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Debt Dynamics

- The relative debt fell *in spite of* deficits in 21 of the 29 years, with the debt increasing by 42%. How?
- 1946-1974, deficits caused the debt to grow, but not as fast as the economy was growing.
- While the debt grew by 42%, GDP (nominal) grew by 550%

You don't need a surplus to reduce the *relative* debt:
You just need GDP to grow faster than the debt



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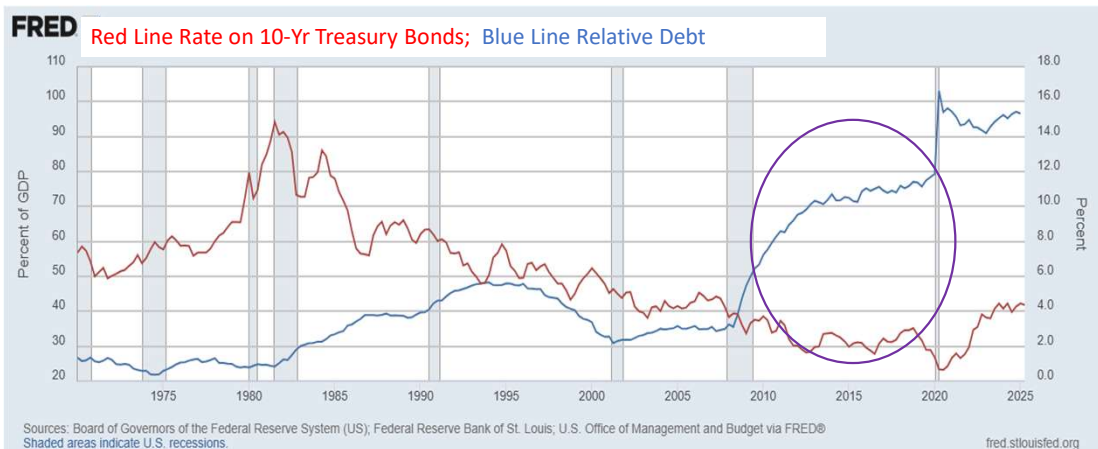
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Traditional View: Debt and Deficits Raise Interest Rates

1. **Crowding Out via higher interest rates:**
 1. **Private:** less investment and over time leads to a smaller capital stock and reduced future output.
 2. **Government:** primary surplus needed to stabilize the debt is larger; i.e., less programmatic outlays or higher taxes
2. **Foreign Borrowing: Higher interest rates lead to foreign capital inflows or foreign borrowing (Larger trade Deficit!). With foreign borrowing, some of our GDP is paid to foreigners as interest.**



The Dog that Didn't Bark; Rising Interest Rates?

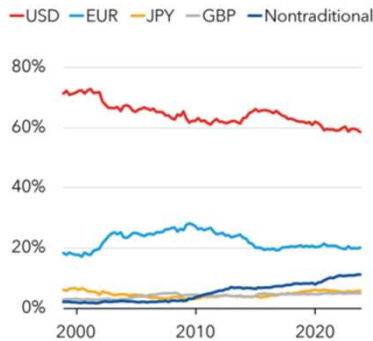


Why do Foreigners Buy US Treasuries?

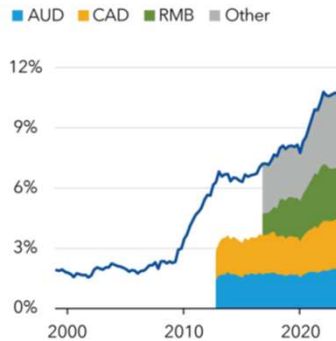
- **Market for Treasuries is the deepest, most liquid and safest capital market in the world.**
- **US economy has a history of political and economic stability.**
- **We enjoy “An exorbitant privilege” (Valery Giscard d’Estaing): The dollar is the largest international reserve currency.**
 - Most trade transactions are quoted in dollars, e.g., oil.
 - With some exceptions, foreigners borrow in dollars. E.g., Yankee bonds
- **World has(d?) an insatiable demand for safe US assets.**

Demand for Dollars by Central Banks

Currency share of FX reserves



Nontraditional share breakdown

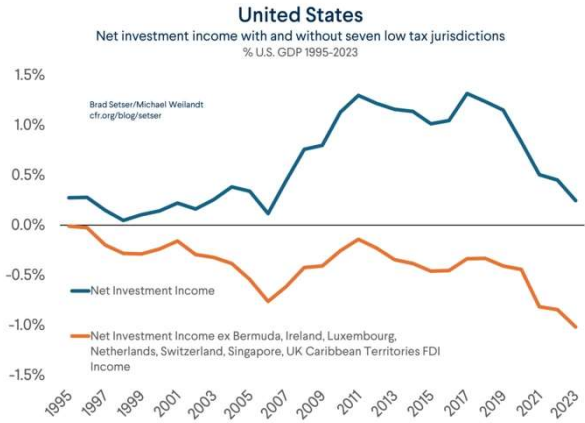
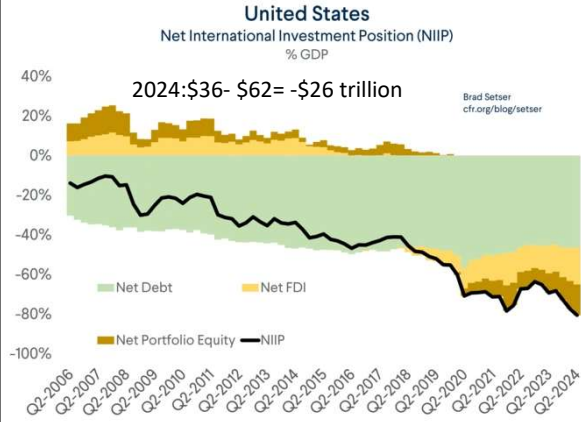


Sources: IMF COFER; Arslanalp, Eichengreen, and Simpson-Bell (2022, updated).
 Note: The “big four” currencies are the US dollar, euro, Japanese yen, and British pound.
 Nontraditional are all other currencies. AUD = Australian dollar. CAD = Canadian dollar.
 RMB = Chinese renminbi. China became a COFER reporter between 2015 and 2018.



Reflections of "Privilege"

Includes over \$1 trillion in US currency,
45% of total currency

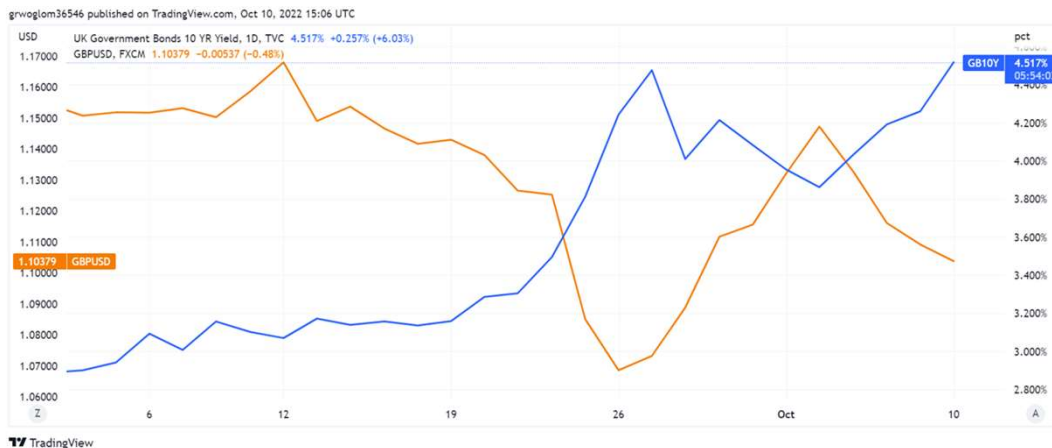


CBO on the Costs of "High and Rising Debt"

1. The interest expense portion of the deficit will rise, including payments to foreigners.
2. Crowding out of private investment.
3. **"The likelihood of a fiscal crisis in the United States would increase." (emphasis added)**
4. Slow erosion of confidence in the U.S. dollar as an international reserve currency leading to higher interest rates.
5. Policymaker constraint in using deficit-financed fiscal policy to respond to unforeseen events.

CBO, "Budget and Economic Outlook: 2022-2032," May 2022, pp15-16.

Fiscal Crisis Preview: Liz Truss & Head of Lettuce



What would a Fiscal Crisis Look Like?

Foreigners lose confidence in the dollar and sell Treasuries in exchange for assets denominated in their own currency,

1. Sale of Treasuries raises interest rates, worsening our fiscal outlook.
2. Trading of Foreign for US assets lowers US exchange rate.
 - a. Raising the price of imports thereby increasing inflation.
 - b. Lowering the foreign currency returns on all US assets, exacerbating 1.

Could the Fed Bail us Out?

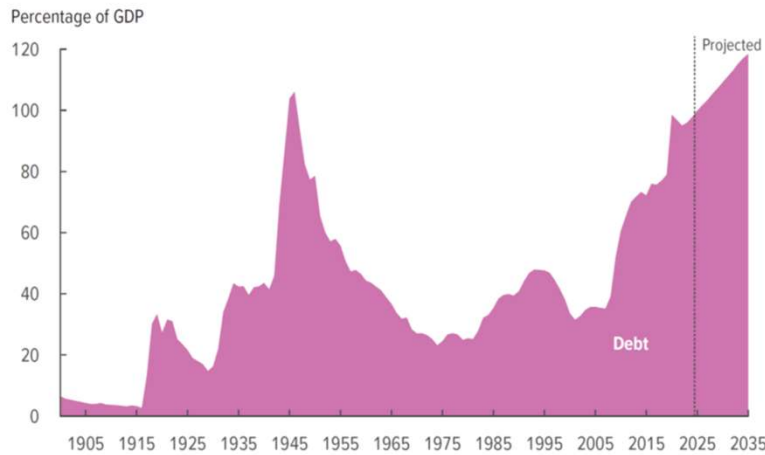
1. It could buy Treasuries and prevent the rise in interest rates.
2. Insufficient foreign assets to prevent the fall in the exchange rate,



Bottom Line: We Need to Worry about the Debt

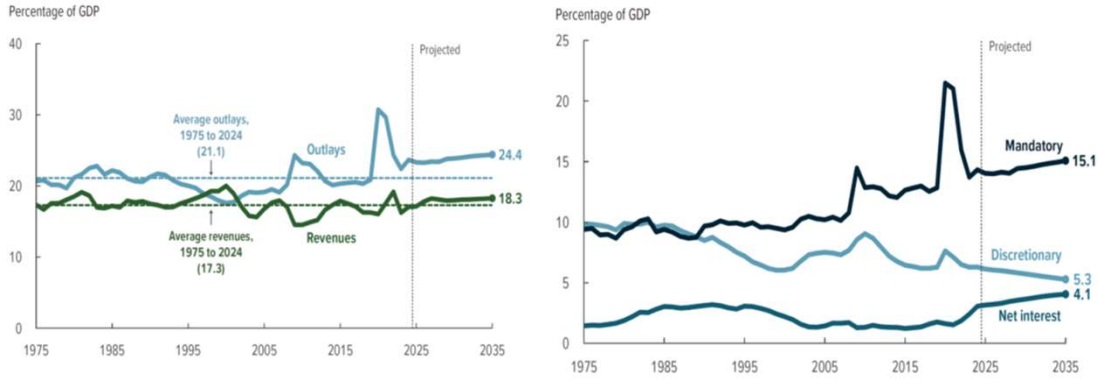
1. Economist don't really know why they fell to such low levels over the past 20 years. What will they be in the next 20?
2. A fiscal crisis should be avoided at all costs.
3. The good news is we may be able to stabilize the relative debt without a running a surplus.

But is this Problem Impossible?



By 2054, CBO publicly-held debt will rise to 166% of GDP

The Blueprint for a Crisis?



But, these are “projections,” not forecasts!

CBO Spending Options

Table 1-1.

Projected Savings From Options for Reducing the Deficit

Billions of dollars

Option	Title	Savings, 2025–2034*
Mandatory Spending		
1	Reduce Subsidies in the Crop Insurance Program	47
2	Raise Fannie Mae’s and Freddie Mac’s Guarantee Fees and Decrease Their Eligible Loan Limits	7 to 15
3	Eliminate the Add-On to Pell Grants, Which Is Funded With Mandatory Spending	44*
4	Establish Caps on Federal Spending for Medicaid	459 to 893
5	Limit State Taxes on Health Care Providers	48 to 612
6	Reduce Federal Medicaid Matching Rates	69 to 561
7	Increase the Premiums Paid for Medicare Part B	510
8	Reduce Medicare Advantage Benchmarks	489
Discretionary Spending		
28	Reduce the Department of Defense’s Annual Budget	959
29	Cap Increases in Basic Pay for Military Service Members	22*
30	Replace Some Military Personnel with Civilian Employees	17*
31	Stop Building Ford Class Aircraft Carriers	15
32	Cancel the Long-Range Standoff Weapon	15
33	Cancel the Army’s Future Long-Range Assault Aircraft	11
34	Reduce the Size of the Bomber Force by Retiring the B-1B	6
35	Reduce the Size of the Fighter Force by Retiring the F-22	29
36	Reduce the Basic Allowance for Housing to 80 Percent of Average Housing Costs	17*
37	Reduce Funding for International Affairs Programs	187
38	Reduce Funding for International Affairs Programs	48

We need \$700 billion *per year* to stabilize relative debt.

How about Revenue “Enhancement?”

Option 46—Revenues

Impose a Surtax on Individuals' Adjusted Gross Income

Billions of dollars	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	Total	
											2025–2029	2025–2034
Decrease (-) in the deficit												
Impose a surtax of 1 percentage point on AGI above \$20,000 for single filers and \$40,000 for joint filers	-70.7	-124.4	-131.3	-139.0	-145.2	-151.7	-158.6	-165.9	-173.1	-180.4	-610.6	-1,440.1
Impose a surtax of 2 percentage points on AGI above \$100,000 for single filers and \$200,000 for joint filers	-49.5	-89.1	-94.2	-101.2	-105.8	-110.8	-116.3	-122.1	-127.9	-133.9	-439.8	-1,051.0

Option 51—Revenues

Change the Taxation of Assets Transferred at Death

Billions of dollars	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	Total	
											2025–2029	2025–2034
Decrease (-) in the deficit												
Enact carryover basis for assets held until death	-1.0	-7.5	-11.5	-15.1	-18.6	-21.9	-25.1	-28.5	-32.0	-35.6	-53.7	-196.9
Include accrued capital gains in the last income tax return of decedents	-9.1	-48.7	-46.8	-48.8	-51.9	-55.8	-60.5	-65.8	-71.4	-77.3	-205.3	-536.1

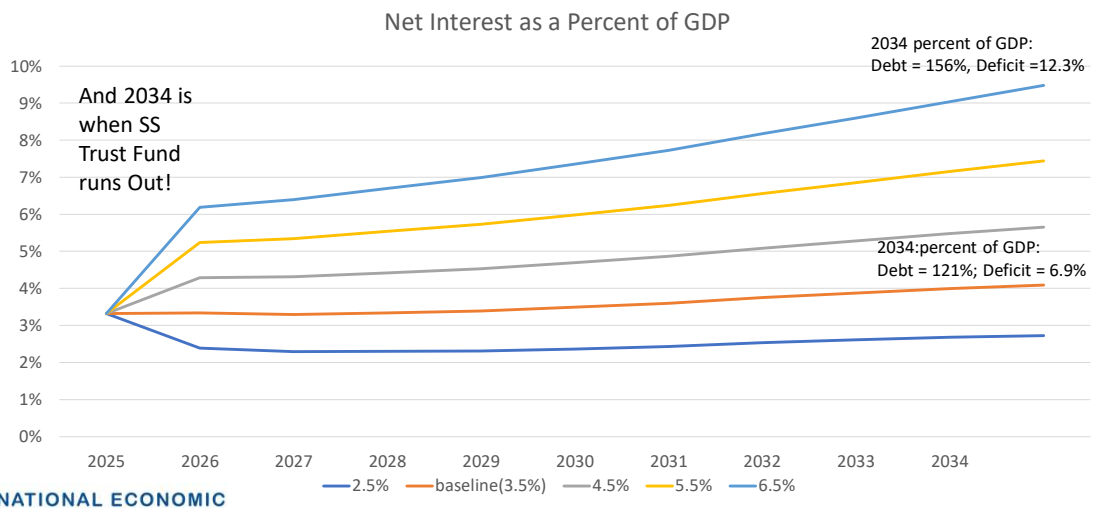


And, It Gets Worse

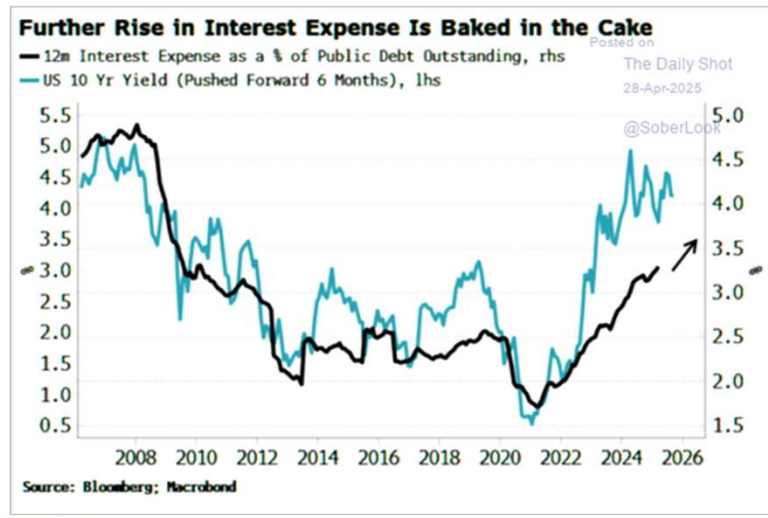
- CBO Projections have to be based on forecasted future interest rates.
- Remember, nobody really understands why interest rates fell from 2000-2020.
- What if interest rates rise (and they have been)?



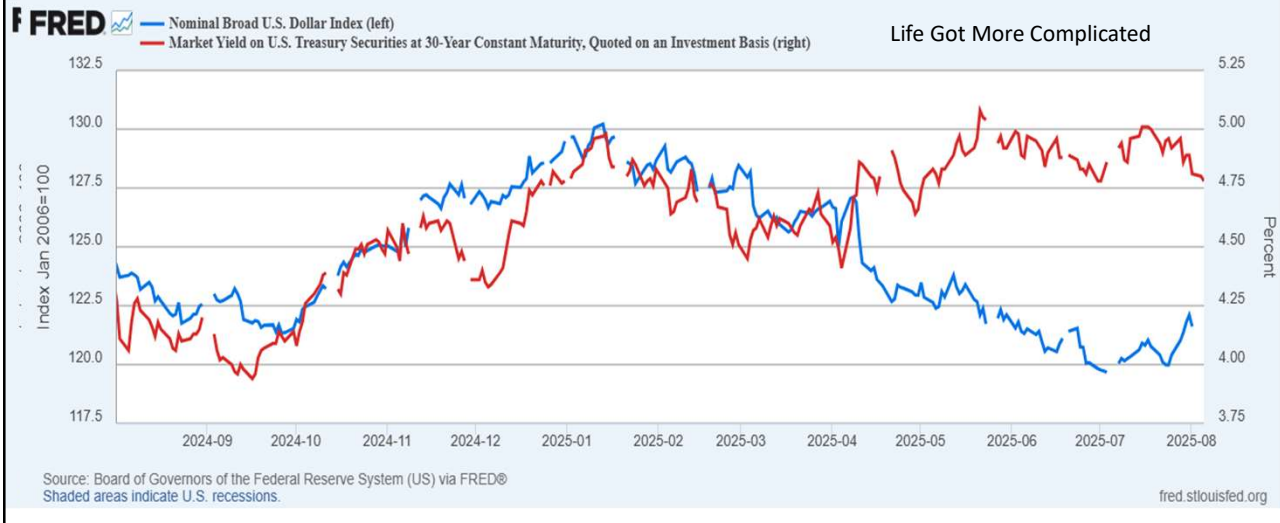
Pretty Bad



The Future of Interest on the Debt?



What About Those Gloomy Signals?



Brookings on a Fiscal Crisis (2/12/2025)

In most ... scenarios, it is likely within policymakers' power to avoid a crisis altogether, even given the projected increase in federal borrowing. In other words, a fiscal crisis is more likely to result from political missteps (Liz Truss?). These missteps include threats to default or efforts to undermine credibility of the Federal Reserve as well as enactment of policies that sharply increase deficits and thus raise the specter of strategic default.

<https://www.brookings.edu/articles/what-are-the-risks-of-a-rising-federal-debt/>

How Did We Get in This Mess?

- Partly, because of the “exorbitant” privilege combined with industrializing Asia.
- Japan, South Korea and China followed a similar playbook.
- Develop the industrial sector through subsidies, tariffs and an “undervalued” currency.
- Sort of an “Infant Industry” argument.



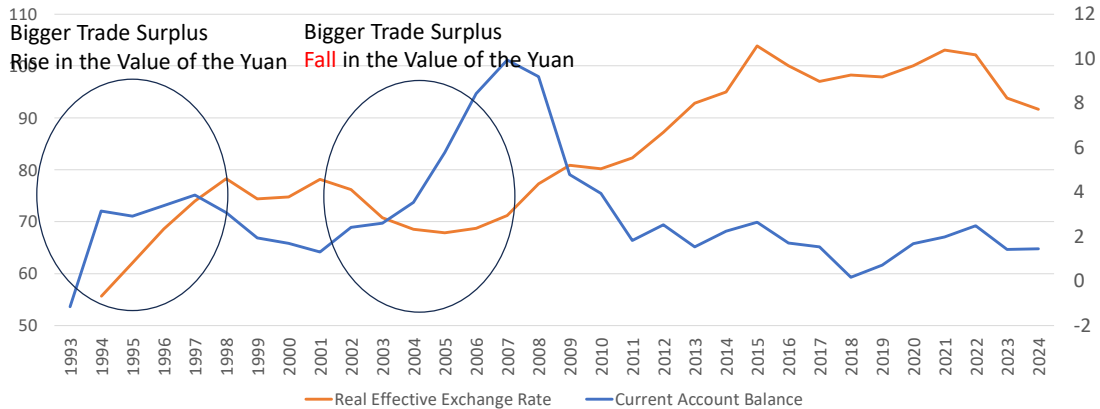
How to Undervalue Your Currency

1. Restrict domestic consumption to generate an increase in National saving and a trade surplus.
2. Normally a trade surplus would lead to an increase in the supply of dollars on foreign exchange markets and a fall in the value of the dollar (or rise in the value of US currency).
3. Offset the rise in the value of the your currency by buying US financial assets, e.g., US Treasury bonds. (which also helps to restrict domestic consumption).



The Chinese Example

China's "Real" Exchange Rate and Current Account



Chinese Consumption: 2003, 46.0% of GDP; 2007, 39.9%

Holding of US Treasury Bonds: 2003, \$147b; 2007, \$471b

Why Didn't the US Respond?

- Cheap Chinese goods kept US inflation low and benefited US consumers.
- Low US interest rates made the job of financing the deficit easier.
- Diplomatic reasons: "The US wants a prosperous China."
- Instead, the Fed cut interest rate to raise domestic spending enough to accommodate growing imports, while maintaining domestic production.
- But manufacturing takes a big hit.

The Rise of a Heterodox Critic

- **Michael Pettis (based in a Chinese University!), *The Great Rebalancing, 2013.***

In the *WSJ*, April 30, 2025

Letting other countries take the lead in manufacturing harms the American economy. The U.S. accommodates other countries' successful industrial policies by absorbing their negative consequences—namely, by absorbing global savings imbalances, running trade deficits and offshoring manufacturing.

U.S. leaders must adopt a strategic approach to industrial policy...and, more important, by reversing the U.S. role in absorbing global trade and capital imbalances.

But, How Would We Do This?

- **The “Mara Lago Accords”:**

- Tariffs
- Discourage Capital inflows by
 - o Forcing Foreigner governments to own 100-year Zero Coupon bonds.
 - o Charging foreigners a fee for owning US Treasuries.

Sound Anything Like a Brookings Mistep?

How about “discouraging capital inflows” by cutting the deficit to decrease the need to borrow from foreigners!

Was that on the Congressional Agenda?

- **Sadly no.**
- **Liberation Day Tariffs**
- **One Big Beautiful Bill**

What will be the effect of these policies be on National Saving and the Trade Deficit?



What about Entitlements?

Scott Bessent:

"These entitlements are massive. I think the next four years isn't the time to deal with them, that we've got to deal with the discretionary portion of the budget...then the next step is for a future administration to have the confidence to be able to deal with entitlements"

Total Discretionary Spending last fiscal year was \$1.8 trillion.

(There was a "reform" of Medicaid and Food Stamps; about \$600 billion in Federal spending last year.)

But there is no way this could get through the Senate Democrats, right?



Citizen's Guide to "Budget Reconciliation."

- Procedure successfully used 22 times since 1974 to avoid a Senate filibuster.
- Reconciliation can be used for changing taxes and spending (not Social Security) subject to the Byrd Rule.
- Byrd rule:
 1. No extraneous provisions.
 2. No increase in the deficit after 10-year window.
- Reconciliation games played by both parties:
 1. BBB.
 2. 2017 Trump Tax Cut



Reconciliation and CBO Projections


- For the CBO to be effective it must be perceived to be (and must be) nonpartisan.
- Therefore, CBO "baseline" projections and legislative scoring must not try to predict changes in legislation.
- Instead, CBO must analyze the data without making assumptions about changes in law (2017 tax cut phased out in 2025)
- CBO is allowed to provide analyses of policy options.
("Options for Reducing the Deficit: 2025 to 2034,"
<https://www.cbo.gov/publication/60557>)



The Reconciliation Game in Action

By Fiscal Year, in Billions of Dollars

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-2022	2018-2027
Total Estimated Changes in Revenues	-144.3	-270.9	-257.0	-234.8	-199.6	-163.9	-148.9	-146.4	-61.5	-19.8	-1,107.0	-1,649.0
Total Changes in Direct Spending												
Estimated Budget Authority	-8.6	9.1	1.8	-13.9	-21.8	-26.0	-28.8	-32.1	-21.1	-52.9	-33.3	-194.1
Impact on Deficit	135.7	280.0	258.8	221.0	177.8	137.9	120.1	114.3	40.4	-33.1	1,073.7	1,454.9

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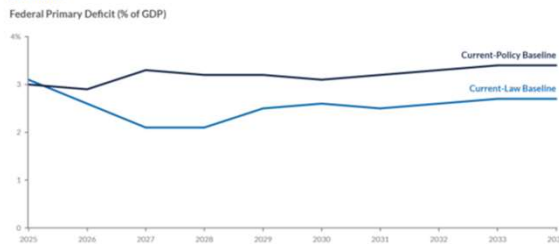
A New Wrinkle to the Reconciliation Game

• When is a Tax Cut, Not a Tax Cut: Change the Baseline

- Current Law
- Current Policy

2034:
 Current Policy, 3.4% of GDP
 Current Law, 2.7% of GDP
 0.7% of 2034 GDP
 =\$300billion

The 10-year deficit would be larger under a current-policy baseline than a current-law baseline



Source: Congressional Budget Office. [Embed](#) [Download image](#)
 Notes: Current law baseline is from June 2014 projections and current policy baseline is from alternative assumptions. Current policy baseline reflects selected alternative assumptions about revenue policies related to the 2017 Tax Cuts and Jobs Act. 

Consequences: Taxes, Spending & Tariffs

2025-2034 Net Effects on the Deficit

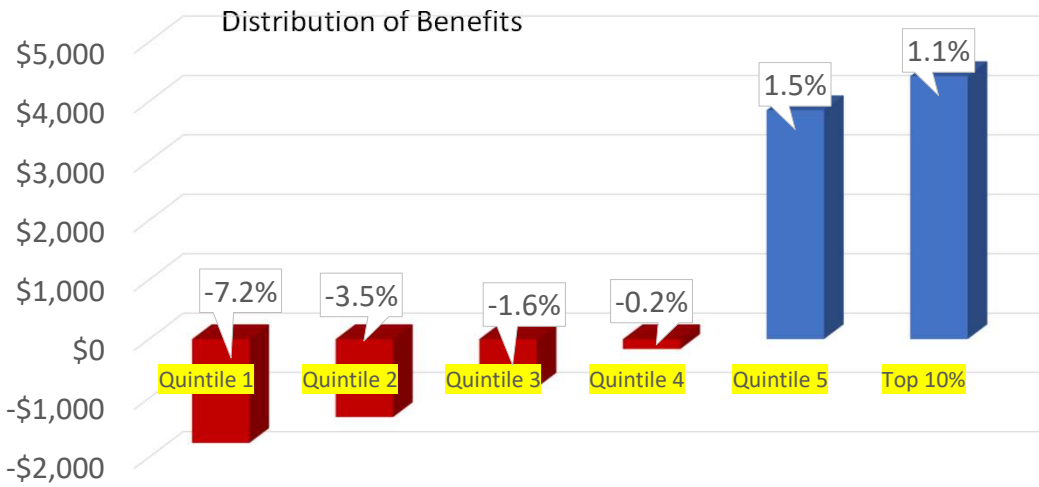
One Big Beautiful Bill		Tariffs	Added Interest		Total
	Primary Deficit	Primary Deficit			
As Written	3062	-2125	182		1119
Permanent	3787	-2125	322		1984



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Authors Calculation from: <https://budgetlab.yale.edu/research/state-us-tariffs-august-7-2025> & <https://budgetlab.yale.edu/research/financial-cost-senate-passed-budget-bill>

Consequences: Taxes, Spending and Tariffs



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Authors Calculation from: <https://budgetlab.yale.edu/research/state-us-tariffs-august-7-2025> & <https://budgetlab.yale.edu/research/distribution-tax-cuts-new-tax-law>

Famous Economist Quotes



A Cheerful Rudi Dornbusch

Dornbusch's Law:

The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought.

The Wit and Wisdom of Herb Stein



If something cannot go on for ever,

— Herbert Stein —

AZ QUOTES

And, what will be the damage when it stops!

Your Turn

<https://needecon.org/>

grwoglom@amherst.edu

My Website:

<https://sites.google.com/view/macro-current-issues/debt>