FACT SHEET
WHY DEBT MATTERS

PREPARED BY: DEMOCRATIC STAFF, SENATE BUDGET COMMITTEE

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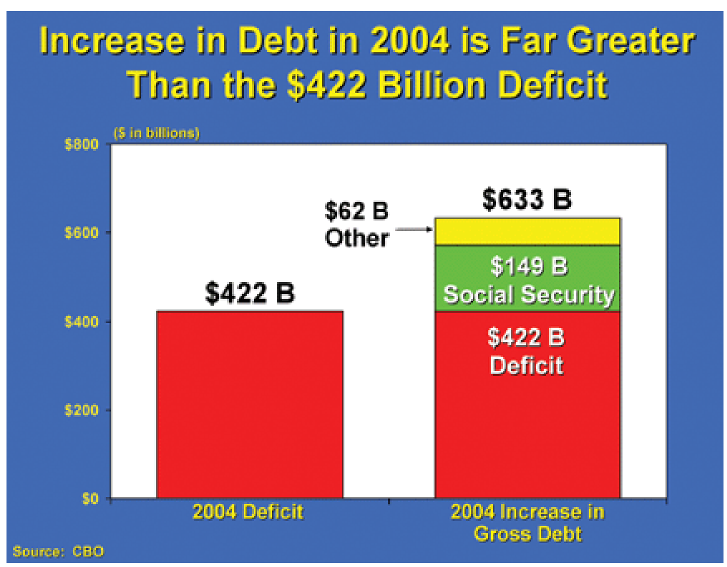
Federal Debt Soaring Under Bush Policies,
Threatening Long-Term Economic Security of Nation

Since President Bush took office, federal debt has soared, with serious long-term consequences for the nation. Record budget surpluses and debt reduction have been replaced with record deficits and a growing mountain of debt. This debt passes on a crippling burden to future generations and threatens the long-term economic security of the nation by:

- increasing our indebtedness to foreign nations – which leaves us reliant on others to finance our borrowing and leaves us vulnerable to foreign creditors;
- weakening our ability to provide promised Social Security and Medicare benefits;
- raising interest rates – which increases the cost of living for average Americans through higher mortgage, credit card, and other loan payments;
- crowding out private sector investment – which slows long-term economic growth; and,
- increasing federal interest payments – which diverts scarce resources from national priorities such as defense, education and health care, and boosts taxes on future generations.

Record Surpluses Turned Into Record Deficits
The President's policies, including his large deficit-financed tax cuts, have helped to wipe out record surpluses. In fact, the budget outlook has worsened every year since President Bush took office – with the deficit expected to reach a record $422 billion this year, $46 billion more than last year.

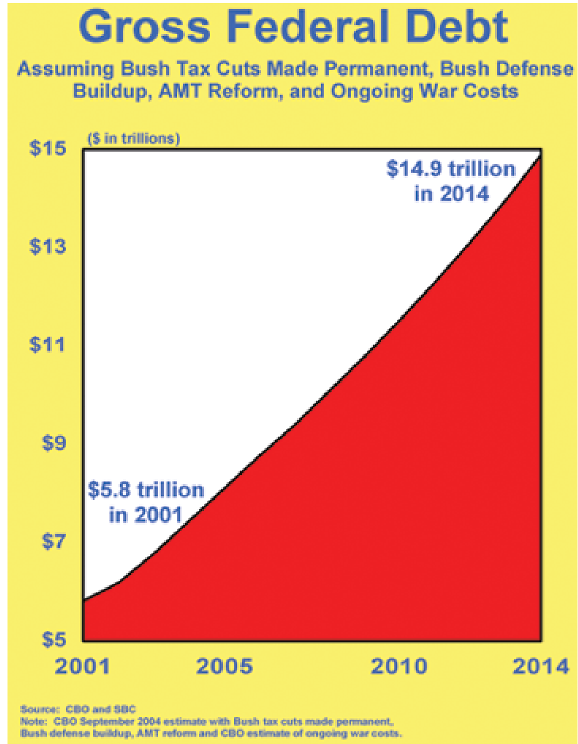


The amount of debt being added this year is actually much more than the $422 billion deficit. When we factor in the money being borrowed from Social Security and other trust funds to pay for other things, the amount being added to the debt this year is over $633 billion.

Despite the President's claims that he will cut the deficit in half, it is clear that large deficits and growing debt will continue into the future if we continue with his policies. Using CBO's September 2004 Budget Update, and assuming the President's tax cuts are made permanent, the AMT is reformed, funding for ongoing war costs is provided, and Social Security is excluded, we can expect large deficits as far as the eye can see. These large deficits translate into a growing accumulation of federal debt, as the nation borrows more and more to cover its expenses.

Soaring Federal Debt Passes on Crippling Burden to Future Generations

From 1998 to 2001, the budget was in surplus and more than $450 billion in publicly held debt was paid down. With a projected 10-year surplus of $5.6 trillion, we were on course to retire the public debt, putting the nation in a good position to prepare for the coming retirement of the baby boom generation. When President Bush took office, CBO projected that the nation's publicly held debt would be virtually paid off by 2008. Now, if we assume the President's tax cuts are made permanent, the President's defense buildup is adopted, the AMT is reformed, and we have ongoing war costs, publicly held debt is projected to approach $5.8 trillion in 2008.



Gross federal debt, which includes funds owed to the Social Security and Medicare trust funds, also has soared under the President's policies. Under the same assumptions noted above, gross federal debt will climb from the $5.8 trillion in 2001, to $14.9 trillion in 2014. This will translate into $46,660 in debt for each American citizen in 2014, a crippling burden for future generations.

The surge in gross federal debt over the last few years has required dramatic increases in the federal debt limit. After five years in which it was not raised at all, the debt limit was raised by $450 billion in 2002 and $984 billion in 2003. And the Bush administration has announced it will run up against the debt limit again this fall unless it is raised yet again. If the $690 billion debt limit increase advocated by the GOP is adopted, the debt limit will have been increased by more than $2 trillion under President Bush – the largest total debt limit increase recorded under any President.

Increased Indebtedness to Foreign Nations Potentially Destabilizing

To cover this increased borrowing, the U.S. is going deeper into debt to foreign countries. Japan, China, the United Kingdom, and Caribbean Banking Centers are now the largest foreign holders of U.S. Treasury debt.

Top Ten Countries Holding Our National Debt

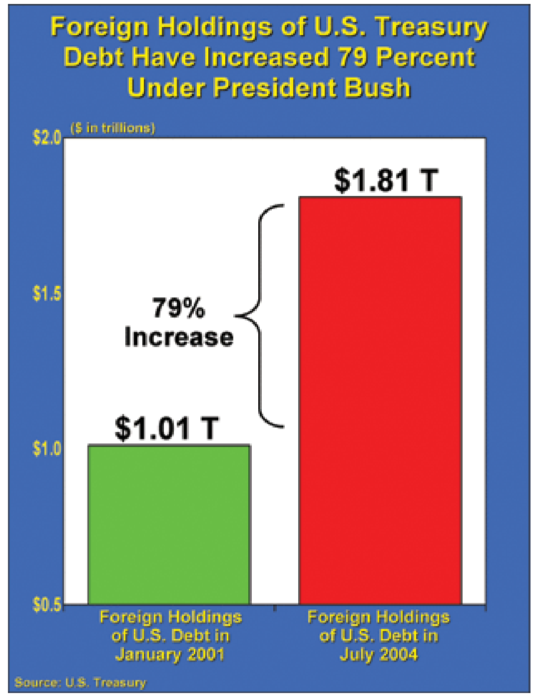
Japan	$696 B
China	$167 B
United Kingdom	$130 B
"Caribbean Banking Centers"	$91 B
South Korea	$62 B
Taiwan	$58 B
Hong Kong	$50 B
Germany	$49 B
Switzerland	$48 B
OPEC	$44 B

Source: Department of Treasury
Note: As of July 2004

In fact, since President Bush took office in January 2001, total foreign holdings of U.S. Treasury debt have risen to $1.81 trillion from $1.01 trillion, an increase of 79 percent. As a result, the share of U.S. Treasury debt held by foreigners has risen to 42 percent from 30 percent over that same time period.

Our reliance on foreign debt could lead to a severe financial dislocation. If foreign investors ever decide, for economic or even political reasons, to stop financing America's debt, U.S. and international currency markets could be thrown into turmoil. For example, foreign investors might withdraw their capital because they conclude that our unsustainable fiscal policies make this country an undesirable place to invest. Earlier this year, the *Washington Post* described this scenario as follows:

> *"Currency traders fretting over that dependency have been selling dollars fast and buying euros furiously. The fear is that foreigners will tire of financing America's appetites. Foreign investors will dump U.S. assets, especially stocks and bonds, sending financial markets plummeting. Interest rates will shoot up to entice them back. Heavily indebted Americans will not be able to keep up with rising interest payments. Inflation, bankruptcies and economic malaise will follow."*



The large amount of our foreign debt leaves our nation vulnerable to the priorities of foreign creditors. The ability of foreign investors to wreak havoc on the U.S. economy by suddenly refusing to finance the U.S. debt also leaves our nation in a more precarious geo-political position. U.S. diplomatic and trade negotiators, for example, could have difficulty making demands of creditor nations, who hold so much of our debt.

Foreign debt has kept interest rates artificially low. Foreign investors' willingness to loan large amounts of capital to the U.S. has kept our interest rates low despite the prospect of large and sustained budget deficits. As the *Washington Post* notes, if that supply of capital should dry up, the U.S. would be forced to raise interest rates to make U.S. Treasury bonds a more attractive investment.

Paying back foreign debt will lower U.S. living standards even without higher interest rates. Foreigners holding our debt expect to be paid back. Ultimately, that means the nation will have to produce enough to meet both our own needs and the demands of foreign creditors. What Americans produce will have to exceed what Americans get to enjoy as income. We will be working harder but enjoying less of the reward.

Weakened Ability to Provide Promised Social Security and Medicare Benefits
The explosion of debt under the Bush administration's policies is occurring at the worst possible time – just on the brink of the retirement of the baby boom generation. Beginning in 2008, the first of the baby boomers will retire, dramatically increasing the costs to Social Security and Medicare. At the same time, fewer workers will be paying into the Social Security and Medicare programs. Today, there are three workers paying payroll taxes for each retiree. That ratio will fall to just two workers for each retiree as the baby boomers retire.

The Bush administration's policies are making this situation much worse. Under the President's budget policies, every penny of the Social Security Trust Fund surplus – $2.4 trillion over the 10-year period 2005-2014 – is being spent on other things. These are resources that should be saved to prepare for the coming demographic tidal wave by paying down debt or prepaying the liability.

Higher Interest Rates Increase Cost of Living for Average Americans
Although short-term interest rates have been held down by the inflow of foreign capital and by the Federal Reserve's monetary policy, eventually long-term interest rates will rise in response to the mounting public debt. Federal Reserve Chairman Alan Greenspan confirmed this in testimony before the Senate Banking Committee last year, saying:

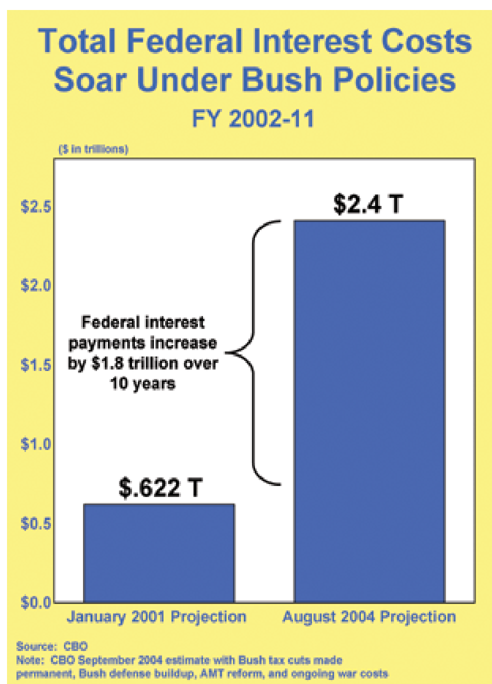
> *"There is no question that as deficits go up, contrary to what some have said, it does affect long-term interest rates. It does have a negative impact on the economy, unless attended."*

These higher interest rates will translate into higher mortgage, credit card, and other loan payments for millions of Americans. In fact, the negative financial impact on most Americans from higher interest rates will outweigh any benefit they may receive from recent tax cuts. For example, a one percentage point increase in mortgage interest rates will boost the required payment on a $150,000 mortgage by $100 per month – which alone is more than the average tax cut received by a typical middle-income family.

The increasing indebtedness of American households also raises the threat from higher interest rates. Since the beginning of 2001, mortgage debt has increased by 44 percent and now stands at $7 trillion. Over this same period, home equity loans have jumped by 54 percent and installment debt, including credit card debt, has risen 17 percent. Americans have taken on these new debts largely in an attempt to maintain their living standards in a struggling economy. Since much of this private debt is set at variable rates, any increase in borrowing costs could have a severe and immediate impact on these families.

Debt Crowds Out Private Sector Investment and Slows Long-Term Economic Growth
To cover its borrowing, the federal government must compete for the same capital that the private sector would otherwise borrow to make investments in plants, equipment, and personnel. This competition for limited capital constrains private sector investment. The reduction in private sector investment, in turn, slows long-term economic growth.

Increased Federal Interest Payments Divert Scarce Resources From National Priorities
The growing federal debt is also leading to a dramatic increase in federal interest payments. These interest payments either divert scarce resources from national priorities such as education and healthcare, or lead to future tax increases. When President Bush took office, interest payments on the federal debt were expected to cost $622 billion over the 10-year period 2002-2011. Now, if we assume that the President's tax cuts are made permanent, the President's defense buildup is adopted, the AMT is reformed, and we have ongoing war costs, federal interest payments are expected to cost $2.4 trillion over that same time period – a $1.8 trillion, or 300 percent, increase.



Growing federal indebtedness also means that any increase in longer-term interest rates will severely worsen our already dire budget outlook by directly increasing government spending for interest on the public debt.