Politicians are eyeing up a sacred cow: paying down the national debt

THANKS to three years of budget surpluses, the Treasury has paid down $363 billion of its $3.4 trillion publicly held debt since 1997, $223 billion last year alone. That policy commands the sort of support that usually occurs only in time of war. The two parties vie with one another to put ever more items of budget spending "off limits" so that the surplus can be used to pay down debt as fast as possible. Alan Greenspan, the chairman of the Federal Reserve Board, has framed the terms of the debate through his repeated assertions that paying down debt should take precedence over tax cuts or (horrors) spending increases.

But now politicians are testing how far this commitment should take them—and even what exactly it means. Their debates are largely technical but the implications are not. They raise the prospect that the federal government will end up owning substantial amounts of private assets. They reveal, albeit in rudimentary form, sharply different approaches to the question of how to reform the Social Security (pensions) system. And they touch on matters such as the Fed's conduct of monetary policy, and what happens if the government does not provide a benchmark instrument to the capital markets.

These issues all start with a single figure. Last month George Bush told Congress that his administration would pay off as much of the public debt as it could, which meant paying off just over $2 trillion over the next ten years (see chart 1). The rest—the irreducible minimum—he said was $1.15 trillion. The figure is not zero because there are two categories of debt that cannot—or cannot easily—be retired. So-called "non marketable" debts, such as savings bonds and bonds owned by foreign governments cannot be bought back. There are roughly $400 billion of these (see chart 2). Then there are $500 billion of debts that mature after 2011 which cannot be bought back before then without incurring "penalty premiums" (see chart 3, further down the page).
The last president to face a similar situation, Grover Cleveland, nicely expressed the problem. "It should be borne in mind", he told Congress in 1887, "that premiums must of course be paid upon such purchase, that there may be a large part of these bonds held as investments which cannot be purchased at any price and that holders who are willing to sell may unreasonably enhance the cost of such bonds to the government."

Mr Bush’s estimate was something of a guess, since no one really knows whether holders of some debts would be willing to sell and at what price. But the figure of $1.15 trillion is within the usual range of estimates and is comparable to the Clinton administration’s figure of $1.23 trillion in its last budget. The figure is also politically important because it enables Mr Bush to argue that he will pay down every dollar of debt that he can and still have money left over for $1.6 trillion of tax cuts and $800m for a contingency reserve. But what if the figure is wrong and more debt could be paid down?

The same day as the president’s speech to Congress, Gary Gensler, Bill Clinton’s under-secretary for domestic finance at the Treasury, argued exactly that. In a letter to the ranking Democrat on the House budget committee, he reckoned that the irreducible debt was only $410 billion-500 billion. If true, and if Mr Bush were to keep his word to pay down every dollar of debt that he can, either tax cuts would have to be less or the contingency reserve would be almost wiped out.

Mr Gensler looked in detail at three components of the irreducible minimum. First, he argued, the administration is under-estimating the amount of late-maturing debt that it can buy back without penalty, based partly on the debt retirement programme so far, which has not incurred penalties.

Second, he disputed the idea that the Treasury would have to issue some new debt during the period when it was buying back the old one. The administration argues this will be needed to keep a balanced portfolio of debts of different maturities. But the Treasury’s group of Wall Street experts, the Borrowing Advisory Committee, this year voted to get rid of the 30-year bond.

Third, he argued that around half of the “non-marketable” debt is actually marketable (that is, it could be bought). A large part of this comes in the form of holdings by state and local governments who, when they have excess money they cannot immediately use, put it in Treasury securities as a safe harbour. Mr Gensler says they do not need to do that.

Given the uncertainties of forecasting the economy over ten years, the actual dollar difference between Mr Gensler’s $500 billion and Mr Bush’s $1.15 trillion is less important than their underlying difference of policy. The administration (supported by Mr Greenspan) says it is desirable to keep things like the operations for state and local governments. Mr Gensler’s much lower number is what you get if you make other policy aims secondary to debt repayment.

You can see the significance of this difference by looking at Social Security. In the next ten years $2.6 trillion will accumulate in the trust fund of the Social Security system. Mr Bush says he will use just over $2 trillion of that to pay down debt. The remaining $600 billion will be kept for Social Security. Unlike Mr Clinton, Mr Bush is questioning the wisdom of setting aside the Social Security surplus entirely for debt repayment.

Repaying the national debt is not like paying off your mortgage. You do not keep going until, one month, you wake up to find yourself the happy owner of your property. Rather, the national debt forces on you a host of tricky policy questions. The size of the irreducible debt is one such. The others are: what happens to monetary policy and to the markets as government debt disappears? And what happens to the budget surplus after the debt is paid off?

**The iceberg issue**

The first questions are in a sense mechanical ones, but no less important for that. Remember that the Fed is a bank and has to balance assets and liabilities. Its liabilities are dollars in circulation. Its main asset to balance the long-term fluctuation in the money supply is its Treasury-debt portfolio ($500 billion now). But what if that...
The Fed has already begun to wean itself off Treasuries. Last year, it restricted itself to a limited portion of any single Treasury issue (between 15% and 35% depending on the issue). Instead, it holds more securities from commercial banks. (It did the same when it was first set up in 1914, though then it used these holdings to direct credit to selected banks and sectors of the economy—a piece of interventionism the Fed now forswears.) The trouble is that Treasury debt is a perfect instrument for the Fed. It has a deep, liquid market. It is risk free. And it raises no concerns about the Fed allocating credit. None of that is true of commercial debt.

The markets use Treasuries as a benchmark. That too is changing. Once the 30-year bond was the benchmark. Now it is the 10-year one. Soon that may have to go. The General Accounting Office has already warned the Treasury to change its debt-management strategy next year to let markets adjust to less debt.

That leaves a longer-term question. What happens if the debt slips to its irreducible minimum (whatever that is) and if government revenues are then still higher than spending? That may not happen if its surpluses disappear. But the administration reckons it will occur in 2008—and Mr Gensler’s more aggressive debt-repayment policies would bring the date sooner.

The idea of the Treasury one day having billions of dollars in cash to spend and no debt to pay off is something of a political iceberg—huge, but mostly below the surface. Some Republicans, such as Dick Armey, the majority leader in the House, are already arguing the excess cash should be used to cut taxes further. The Democrats balk at this and try to change the subject back to debt reduction. But one possibility would be the government investing the excess as a private citizen might—in the stockmarket.

The administration estimates it will accumulate $1.3 trillion of excess cash by 2011 even after the tax cut. That would be enough to buy 7% of the companies listed on the New York Stock Exchange, assuming the market’s capitalisation were to grow in line with the economy. State and local governments already own $2 trillion worth of shares—mostly through pension funds. The big difference is that there are thousands of such funds, and to the extent that they make bad investments for political reasons (eg, buy companies in “their” state), they cancel each other out. In contrast, the federal government would be an 800-pound gorilla in the market, “fostering [as Grover Cleveland put it in the same speech] an unnatural reliance in private business upon public funds.”

Perhaps the most elegant solution is one suggested by Mr Greenspan: use the excess cash to help set up individual retirement accounts, thus financing the transition costs of reforming Social Security, and using the current period of budget surpluses to plan for the day, a decade or so after the debt is paid down, when the retirement costs of the baby boomers will drive the budget back into deficit. But first, politicians have to think through the implications of what paying down the national debt really means. At least they are starting to do that.