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NATIONAL SECURITY RESEARCH DIVISION

# Fiscal Performance and U.S. International Influence

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## Summary

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ADM Mike Mullen has argued, while he was Chairman of the Joint Chiefs of Staff and many times since he left that post, that, “Our national debt is our biggest national security threat.”<sup>1</sup> At one level, Admiral Mullen’s statement is obvious: The difficult U.S. fiscal position and efforts to rectify it constrain government spending for many purposes, including spending for national security. Defense spending has already been cut significantly—from previously projected levels—under the provisions of the Budget Control Act of 2011.

Judgments differ on the consequences of these defense spending reductions for U.S. military capabilities and for national security more generally. Budget constraints have been sufficient, however, to motivate a major adjustment in U.S. national security guidance.<sup>2</sup> In a letter attached to that guidance, then–Secretary of Defense Leon Panetta said, in particular, that the new strategy recognizes that “the Joint Force of the future will be smaller and leaner.”

Beyond their direct affect on military spending, high government debt and the steps necessary to reduce this debt to sustainable levels may be undermining the economic instruments of U.S. power and the U.S. ability to shape global conditions through other than military means.

This report explores the possible linkages between high government debt and plausible instruments of U.S. international influence. Our principal finding is that, to date, high debt levels have not had clearly negative consequences for U.S. international influence. There are, however, some worrying indications that this may change in the future.

### Some Basic Facts About U.S. Government Debt

Figure S.1 shows the evolution of U.S. federal debt held by the public and gross general government debt. The former concept is the common “headline” definition of federal debt. The latter concept includes debt of state and local governments and federal debt held by government trust funds; this is the definition of government debt commonly used for international comparisons. While general government debt is higher, the two definitions of debt show the same historical pattern and are, for most analytic purposes, interchangeable.

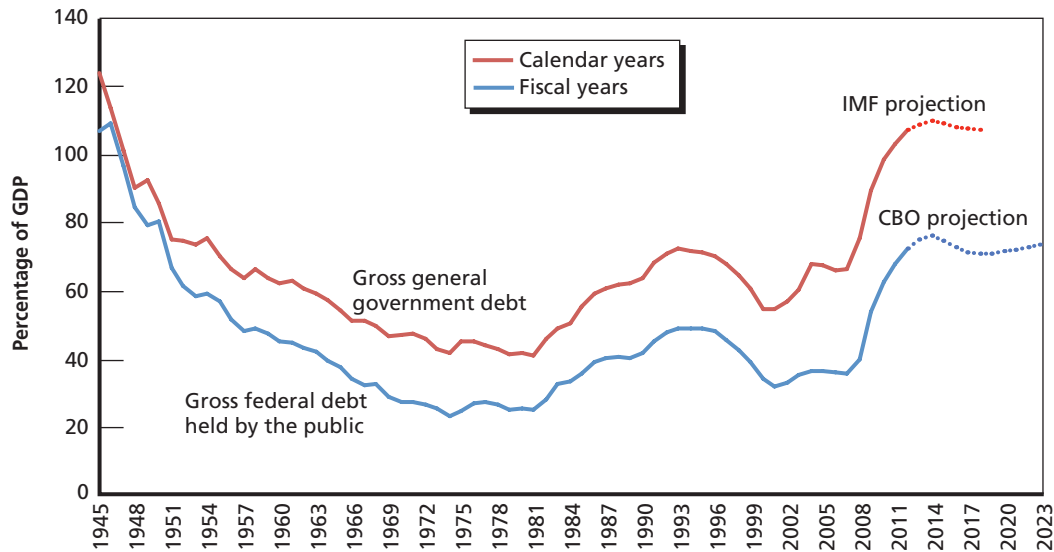
After reaching a low point, as a percentage of gross domestic product (GDP), in fiscal year (FY) 2001, U.S. federal debt has risen rapidly to a level not seen since shortly after World War II. Among the factors that contributed to the higher debt were tax reductions enacted in 2001

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<sup>1</sup> Laura Basset, “Adm. Mike Mullen: ‘National Debt Is Our Biggest Security Threat,’” *Huffington Post*, June 24, 2010.

<sup>2</sup> U.S. Department of Defense, *Sustaining U.S. Global Leadership: Priorities for 21st Century Defense*, Washington, D.C., January 2012.

**Figure S.1**  
**Federal Debt Held by the Public and Gross General Government Debt**



SOURCES: Congressional Budget Office, *Updated Budget Projections: Fiscal Years 2013 to 2023*, Washington, D.C., May 14, 2013; Federal Reserve System Board of Governors, "Flow of Funds Accounts of the United States: Historical Data," in *Release Z.1, Financial Accounts of the United States*, various dates; and International Monetary Fund, *Fiscal Monitor: Fiscal Adjustment in an Uncertain World*, Washington, D.C., April 2013.

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and 2003 (the so-called Bush-era tax cuts), rapidly rising costs for social entitlement programs, increased outlays for military operations in Iraq and Afghanistan, reduced revenues because of the major recession that began in 2008, and aggressive fiscal stimulus measures put in place in 2009 to combat the recession. Outlays for operations in Iraq and Afghanistan are now coming down, stimulus spending has largely run its course, major reductions in discretionary federal spending have been enacted, and some of the Bush-era tax cuts have expired, but the debt will continue to rise through FY 2014. More troubling, the Congressional Budget Office projects that, *even with the full spending reductions required by the sequester*, federal debt will dip only temporarily before the fiscal consequences of an aging population force it higher again.<sup>3</sup>

## Consequences of Government Debt for the Economic Instruments of U.S. Power

The principal basis for U.S. economic power is the simple size of the U.S. economy. The economics profession is beginning to understand that high levels of debt can slow economic growth, especially when gross general government debt surpasses 85 or 90 percent of GDP.<sup>4</sup> U.S. government debt crossed this threshold in 2009, and the negative consequences, if any, for U.S. economic growth probably still lie out in the future.

<sup>3</sup> Congressional Budget Office, *Updated Budget Projections: Fiscal Years 2013 to 2023*, Washington, D.C., May 14, 2013.

<sup>4</sup> See, for example, Stephen G. Cecchetti, M. S. Mohanty, and Fabrizio Zampolli, *The Real Effects of Debt*, Basel, Switzerland: Bank for International Settlements, Working Paper 352, September 2011.

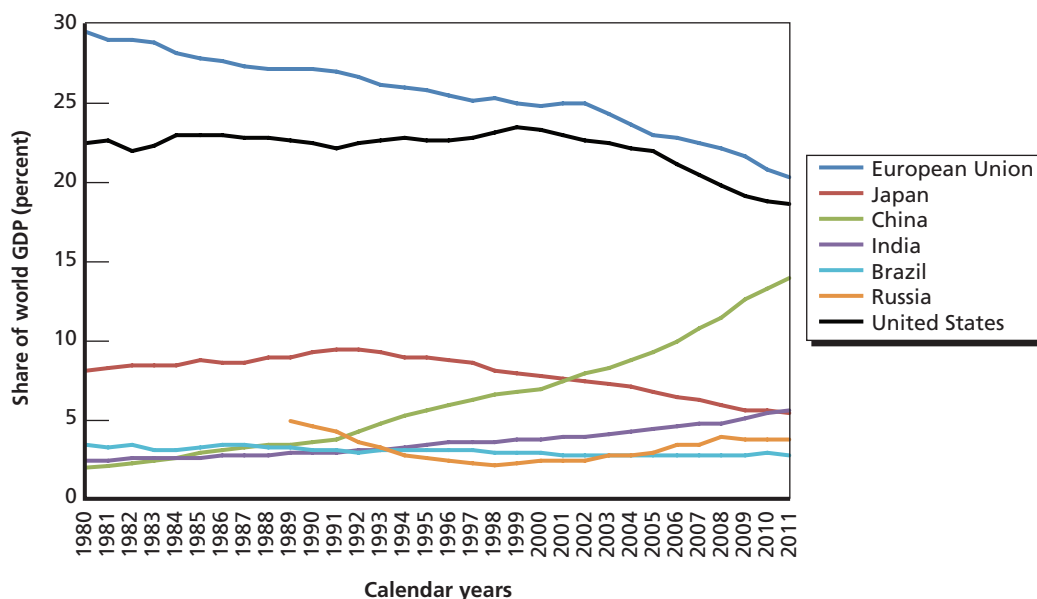
If government debt does eventually slow U.S. economic growth, it will reinforce a trend that has been under way for some years. After holding steady for two decades, the U.S. share of global output has been declining since 1999, or since 2005, discounting the effects of the technology boom in the late 1990s (Figure S.2). The shares of traditional U.S. allies—the European Union and Japan—have been falling even longer, while the shares of China, India, and Russia have been rising.

Also damaging to economic growth is uncertainty over future government economic policy, heightened as a result of confrontations between the White House and Congress over budget matters. Economists at Stanford University and the University of Chicago estimate that the increase in policy uncertainty from 2006 to August 2011 (at the time of the political showdown over the federal debt ceiling) can be expected to foreshadow a decline of more than 2 percent in GDP.<sup>5</sup>

As the U.S. share of global output has fallen, so has the U.S. share of world trade, reducing the ability of the United States to shape the rules of the international trading system. Voting shares in major international financial institutions, such as the International Monetary Fund and the World Bank, are tied to shares of global output and trade; consequently, the United States has seen some erosion of its formal influence in these bodies.

Since U.S. government debt began to rise after 2001, the value of the dollar has declined by 26 percent in price-adjusted terms against the currencies of major U.S. trading partners. The U.S. Federal Reserve Board's very aggressive action to push down dollar interest rates,

**Figure S.2**  
**Shares of Global GDP, Selected Countries (at purchasing power parity exchange rates)**



SOURCE: International Bank for Reconstruction and Development, "World Development Indicators," database, April 16, 2013.

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<sup>5</sup> Scott R. Baker, Nicholas Bloom, and Steven J. Daly, *Measuring Economic Policy Uncertainty*, Economic Policy Uncertainty website, working paper, April 29, 2013.

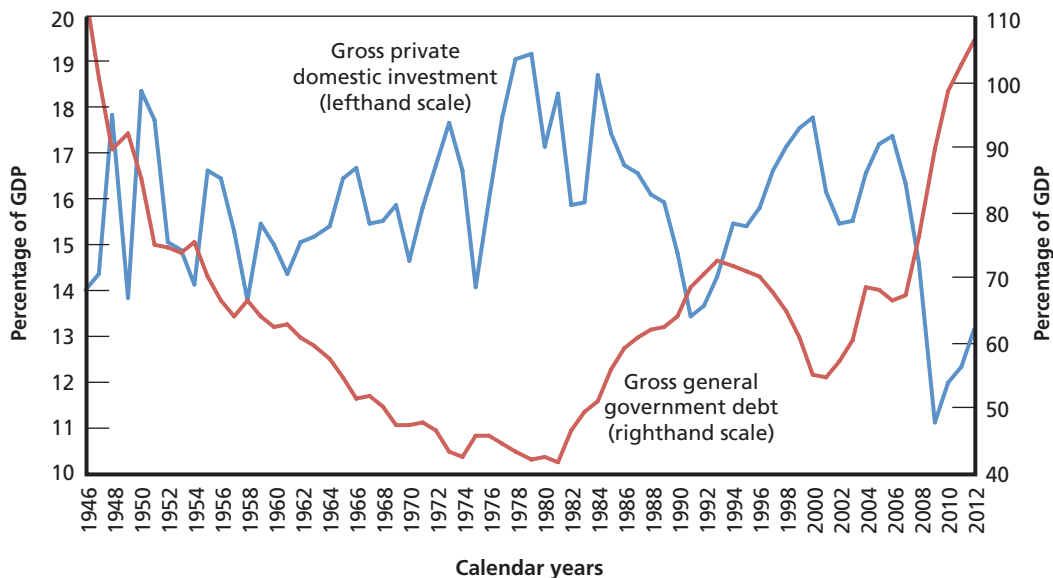
rather than persistent fiscal imbalances, is the most likely explanation of the dollar's weakness, however, and there is no clear link between the value of the dollar and U.S. ability to shape world events. Neither the dollar's position as the world's dominant reserve currency nor the share of foreign exchange transactions involving the dollar—both more plausibly related to U.S. economic interests and influence in the world—has changed significantly since U.S. government debt began to grow rapidly after 2001. U.S. financial institutions retain the confidence of international investors. The share of cross-border bank deposits held in U.S. banks has risen during the period of growing U.S. government debt.

## Debt and Investment in the Nation's Future

The relationship between government debt levels and investments that are important for the nation's future is ambiguous. Throughout the period since the end of World War II, private domestic investment has shown a distinct negative correlation with government debt levels (Figure S.3). From 2010 through 2012, however, this pattern has been broken, with private investment rising, although government debt also continued.

Federal outlays for human capital development (education and training, employment, and social services) rose sharply in FYs 2009 and 2010 as part of the fiscal stimulus program that aimed to counter the ill effects of the Great Recession. But outlays for these purposes fell just as sharply in FYs 2011 and 2012, when the stimulus program had run its course. The

**Figure S.3**  
U.S. Private Investment and Gross General Government Debt (calendar years)



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts Tables*, webpage, May 2013, Table 5.1, and Federal Reserve System Board of Governors, *Release Z.1*, various dates.



Office of Management and Budget (OMB) projects that these outlays will decline further in real terms through FY 2018.<sup>6</sup>

Federal spending for major capital projects (including grants to states for such projects) showed some upward movement as a share of GDP as the federal debt grew from FY 2001 through FY 2010. But since then, it has stalled.<sup>7</sup> Federal spending for this purpose is dominated by military-related capital projects, and the stagnation in this account is mostly a result of slower growth of military capital projects. Federal investments in nonmilitary capital projects have remained generally stable as a share of GDP since the early 1990s. No projections of federal capital spending in future years are available.

Federal outlays for research and development seem to have been unaffected by rising federal debt, remaining roughly constant as a fraction of GDP since the early 1990s.<sup>8</sup>

## What Might Have Happened

Economic power (or any sort of national power, for that matter) is exercised best in the process of creating institutions and conditions that advance U.S. national interests and simultaneously benefit the global community. Historically, the United States has used its economic strength and influence to play leading and constructive roles in creating, shaping, or sustaining numerous important international institutions, programs, and initiatives.

But what has the United States accomplished recently? Have high government debt and a political system seemingly incapable of resolving disputes over fiscal policy undermined the U.S. ability or willingness to exercise international leadership? The record since 2001 is mixed.

The United States has organized effective international economic sanctions against Iran, for example. Some U.S. proposals on international financial regulation—requiring large financial institutions to plan in advance for resolving their own affairs in the event of future crises, for example—have gained international support. Other proposals—separation of commercial and investment banking and limitations on proprietary trading—have fared less well however. Innovative U.S. legal approaches to enforcing international financial sanctions and combatting money laundering are being copied abroad.

But the United States has been conspicuously absent from international schemes to increase the resources available to the International Monetary Fund, while potential rivals for international influence—China, Russia, and Saudi Arabia—have pledged support. The United States has not provided financial support to indebted allies during the Eurozone debt crisis. On at least one occasion, policy advice from senior U.S. officials to Eurozone governments was rejected with sharp references to the U.S. inability to control its own borrowing. More recently, however, U.S. urging that Europe should temper austerity measures has gained some support. The United States has not been able to convince other nations to bring the Doha Round of multilateral trade negotiations to a successful conclusion, but the United States has taken a leading role in creating a trans-Pacific trading arrangement and a U.S.–European Union trade pact. U.S. economic difficulties have precluded broad financial assistance to countries trying

<sup>6</sup> OMB, *The President's Budget for Fiscal Year 2014, Historical Tables*, April 2013b, Table 8.7.

<sup>7</sup> OMB, 2013b, Table 9.3.

<sup>8</sup> OMB, 2013b, Table 9.7.

to transform their economies after the Arab Spring. Fiscal constraints have also diminished U.S. capacity to resolve important domestic issues—high costs for poor health care outcomes, weak public education systems, growing income inequality, for example—risking the social and political cohesion at home necessary to deal confidently and effectively with the rest of the world.

Some prominent commentators (see specific references in Chapter Six of this report) have argued that the United States is withdrawing from world leadership, that fiscal problems have forced it to limit military responses to international security challenges, and that the U.S. voice in international affairs has been diminished. We do not find clear evidence to support these propositions, but neither can we reject them convincingly. Certainly, the U.S. fiscal predicament cannot be strengthening U.S. international influence.

### **What Is to Be Done?**

The United States faces a dilemma. A persistently high level of government debt threatens future economic growth and constrains the ability of the government to act in pursuit of national interests, both international and domestic. Yet efforts to bring down the debt will further constrain government outlays and action—possibly for many years into the future. History suggests that countries seldom grow their way out of burdensome debt. Actions to increase government revenues or constrain expenditures are necessary. Undoubtedly, there is room to increase government revenues, particularly by eliminating unproductive tax preferences. But spending restraint will also have to play a major role.

Opportunities to reduce discretionary expenditures further are limited. Discretionary expenditures, defense and nondefense, today account for less than 7 percent of GDP, less than one-half the share of entitlement spending. Constraining entitlement spending will minimize the need to reduce outlays that contribute directly to U.S. international influence—defense, international representation, and assistance—and that create future productive capacity—investments in infrastructure, research and development, and education. Unfortunately, current legislation is exactly the reverse of this. The Budget Control Act mandates restraint in discretionary spending only; spending for entitlements is exempt from cuts. Preserving U.S. international influence will require a different approach.