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TO: Interested Parties

FROM: Anne Kim, Director, Middle Class Project, and Stephen Rose, Senior Economic Fellow

SUBJECT: Why deficits matter: the pocketbook impact of the federal deficit on the middle class.

"Reagan proved that deficits don't matter."

--Vice President Dick Cheney[1]

Conservatives say that deficits don't matter, and they've spent the nation into a ditch to prove it. Under President Bush, the federal budget deficit is expected to reach an historic high of $1.1 trillion by 2011.[2] It's a radical turnaround from the $1.2 trillion *surplus* projected just six short years ago in 2000.[3]

Clearly, conservatives in Washington haven't found a way to do what most governors, mayors, school principals, small business owners, and American families must do – live within their means. The Bush administration and conservative Congress have heaped debt onto the backs of the next generation of Americans – a debt that will be increasingly tough to pay off.

But that's an abstraction. The question is this: Do deficits really matter in the lives or ordinary Americans today? You bet. And Alan Greenspan would agree. In 2003, the Federal Reserve under Greenspan conducted a study[4] on the impact of the deficit on interest rates. This study concluded that for every percentage point increase in the deficit as a share of gross domestic product (GDP), long-term interest rates will rise by a quarter percent.

Since 2000, the budget deficit as a share of GDP has risen by about 4 percent.[5] Using the Fed's analysis, this means that the current deficit will end up increasing interest rates by more than a full percentage point.

For middle-class families, the deficit means two things:

- Paying as much as $1,700 a year in unnecessary interest for consumer debt and home mortgages; and
- One out of every twelve federal tax dollars spent by the federal government is wasted on making interest payments on the national debt.

Dick Cheney and other conservatives insist that "deficits don't matter." We lay out the real costs of deficits to average Americans in the next section.

The pocketbook impact of the deficit on the middle class

To calculate the "pocketbook effect" of a 1 percent increase in interest rates on a typical consumer, we looked at five types of debt:

- Home mortgages
- Auto loans
- Student loans
- Credit card
- Small business loans

The following analysis shows the monthly and annual impact of a 1 percent rate increase:

Home Mortgage

National median home price in July 2006: $230,000[6]

Principal balance on mortgage, assuming 20% down payment: $184,000.

Additional amount per month of a 1% increase in interest rates, 30-year mortgage: $115[7]

Additional amount per year: $1,380

Auto loan:

Average price of a new car in 2006: $29,200[8]

Additional amount per month of a 1% increase in interest rates, 5-year loan, no down payment: $14[9]

Additional amount per year: $168

Student loans:

Average balance on graduation: $19,300[10]

Additional amount per month of a 1% increase in interest rates, 15-year loan: $11

Additional amount per year: $130

Credit cards:

Median credit card balance among households with credit card debt, 2004: $2,100[11]

Additional amount per month of a 1% increase in interest rates: $6[12]

Additional amount per year: $74

Small business loan:

Additional amount per month, 10-year loan, $200,000 principal: $104

Additional amount per year: $1,248

GRAND TOTAL—ANNUAL INCREASE IN PAYMENTS[13]

Home mortgage:	$1,380
Auto loan:	$ 168
Student loan:	$ 130
Credit card:	$ 74
TOTAL	**$1,752**
Small business loan	$1,248
TOTAL	**$3,000**

Impact of paying interest on the national debt

Another side effect of deficit spending is that the federal government has to make interest payments on the money it borrows. There is probably no greater waste of taxpayer dollars than the budget item "interest payment on the national debt." This year, that budget item totals more than $200 billion. That's more than what the government spends on education, transportation, NASA, national parks, and the Department of Energy – combined!

According to the Congressional Budget Office, approximately *one in every twelve federal dollars is spent to pay down interest on the debt.*[14] That's one in every twelve tax dollars that taxpayers shouldn't have to pay—or one in every twelve tax dollars that's not going toward more college aid, better schools, homeland security, etc. etc.

This means that a significant portion of the average American's tax bill is wasted on paying interest on the national debt. For example, a typical middle-class taxpayer with adjusted gross incomes of between $50,000 and $75,000 paid an average of $5,500 in federal taxes. $454 of that amount was wasted on paying interest on the national debt.

Dick Cheney and his conservative allies believe deficits don't matter. Clearly they do, and clearly they hurt the middle class.

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[1] This quote of Vice President Cheney was attributed to Treasury Secretary Paul O'Neill, as reported by Ron Suskind in his book, "The Price of Loyalty."

[2] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2007-2016," available at http://www.cbo.gov/ftpdocs/70xx/doc7027/01-26-BudgetOutlook.pdf.

[3] Congressional Budget Office, http://www.cbo.gov/execsum.cfm?index=2241&from=1&file=exsum.htm

[4] Laubach, Thomas, "New Evidence on the Interest Rate Effects of Budget Deficits and Debt," available at http://www.federalreserve.gov/pubs/feds/2003/200312/200312pap.pdf.

[5] Government Accountability Office, http://www.gao.gov/cghome/pubstrat20050131/img7.html. In 2000—a time of budget surpluses—the deficit as a share of GDP was zero.

[6] National Association of Realtors, http://www.realtor.org/PublicAffairsWeb.nsf/Pages/EHSJuly07?OpenDocument. Metro information on median home prices is available at http://www.realtor.org/PublicAffairsWeb.nsf/Pages/2ndQtrMetros06

[7] Our calculations were made using the following mortgage payment calculator: http://www.interestratecalculator.com/mortgage/mortgage.html. The following chart from Freddie Mac also shows monthly payments for a $150,000 mortgage at different interest rates: http://www.freddiemac.com/news/factbook/pdf/reporter-factbook-p3.pdf.

[8] Comerica Auto Affordability Index, available at http://www.comerica.com/Comerica_Content/Corporate_Communications/Docs/Auto_Affordability_Index.pdf#search=%22comerica%20auto%20affordability%20index%22.

[9] Amounts were calculated using the following auto payment calculator from www.edmunds.com: http://www.edmunds.com/apps/calc/CalculatorController

[10] National Center for Education Statistics, http://nces.ed.gov/programs/coe/2004/section5/indicator38.asp.

[11] Federal Reserve, Survey of Consumer Finances, http://www.federalreserve.gov/Pubs/oss/oss2/2004/bull0206.pdf

[12] These calculations were made using the following interest calculator: http://www.bankrate.com/brm/calculators/credit-cards.asp

[13] This grand total reflects a “worst-case scenario.” The typical household is unlikely to carry all of these categories of debt, at these amounts.

[14] Congressional Budget Office, http://www.cbo.gov/ftpdocs/70xx/doc7027/01-26-BudgetOutlook.pdf.