Who’s Afraid of the Big Bad Debt?

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Americans have grown accustomed to low and stable interest rates and inflation, the promise of Social Security and Medicare benefits, and predictable taxes. However, explosive growth in U.S. federal government debt threatens these and other appealing features of our economy.

Here are some economic realities that Americans do not seem prepared to face. Government services—entitlements, education, roads, national security—must be paid for with taxes, now or in the future. And in the United States, you can’t raise revenues by cutting taxes: that old saw has been proven false repeatedly. Moreover, permanently higher levels of government debt will make us permanently worse off.

Long-term projections by the Congressional Budget Office tell a frightening fiscal tale. In one scenario the ratio of federal debt to gross domestic product—the size of the U.S. economy—rises to over 200 percent 50 years from now. That projection assumes that current tax and spending policies remain in effect forever, with all future budget deficits financed by selling new government bonds. Even scarier is an alternative scenario, which embodies the legislative changes the CBO deems likely: debt is nearly 500 percent of GDP by 2060.

To put these numbers in perspective, the Civil War drove the debt-GDP ratio to about 30 percent; World War I raised it to 33 percent; World War II increased the ratio to 113 percent. Compared to the CBO projections, our past war debts are mere hiccups.

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Although in the past debt has grown rapidly at times, it has always been for explicitly temporary reasons like wars. What’s different now is that in the CBO’s scenarios debt grows relentlessly because our aging population requires ever-increasing old-age benefits. Exploding debt means that fiscal policy is unsustainable: debt outstanding exceeds the government’s ability to make interest payments, leaving no option but to default.

In actual economies, if policy is unsustainable people will stop buying the debt. In fact, when investors first suspect that policy could become unsustainable, they treat government debt as risky and demand a premium on the interest they earn from it. Higher interest rates on debt spread across the economy, raising rates on mortgages and business loans. This is happening in Greece and Ireland. Other European countries appear headed for a similar fate—Italy, Portugal, Spain, and, yes, even the venerable United Kingdom.

For the time being, global investors are happy to buy U.S. government bonds and not demand a risk premium because they do not expect current fiscal policies to last forever. They expect that somehow, at some point, policy will make the necessary adjustments to taxes and spending.

*How and when*, however, are mysteries.

Our political leaders are opaque about future policy adjustments. Opaqueness increases uncertainty and makes it harder for consumers and firms to make good economic decisions. Should I save more because “entitlements reform” will cut my Social Security and Medicare benefits or will my children face higher taxes to support my benefits?

Nobody knows.

So consumers and firms must make blind decisions. Extreme uncertainty paralyzes; it retards economic growth and channels resources into arrangements that insure against fiscal uncertainty.
But there is another, far more insidious, outgrowth of rapidly growing government debt. Debt derives its value from the backing of expected budget surpluses and expected inflation and interest rates. For the Federal Reserve to control inflation, fiscal policy must take care of itself: whenever Congress borrows it must eventually raise taxes or lower spending. Unfortunately, every economy faces a “fiscal limit”—maximum levels of tax collections and minimum levels of spending beyond which it cannot go. At the fiscal limit, taxes and spending cannot adjust to back debt, so for the government to avoid default, monetary policy must provide the backing. Once monetary policy is ensuring debt’s value, it can no longer control inflation. When people anticipate this, it can be impossible for the Fed to control inflation even before the fiscal limit is reached.

So far the United States has avoided a fiscal crisis. Riots in the streets of Athens and steady depreciation of the euro against the dollar, though, remind us that chickens do ultimately come home to roost. Chicken also describes the game American policy makers are playing: one group refuses to raise taxes; another refuses to cut spending. While the game continues, the economy marches ever closer to its fiscal limit and we can expect inflation and interest rates to be higher and the government to renege on some of its promises.

Fiscal troubles accumulate slowly from policy actions—or inactions—over many decades. Bad policies come from bad policy institutions. High-profile “budget summits” and “blue-ribbon commissions” merely paper over the true sources. Real, lasting reforms come only from changing the institutional structures to confront our political leaders with the incentives and constraints necessary to deliver good policies.