Washington policymakers debate deficits and taxes

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If the size of the national debt doesn't really matter, federal taxes are much less likely to go up, which is why an arcane economic debate heating up in Washington could be very important. The debate hinges on whether the size of the national debt, either in absolute terms or as a percentage of the total U.S. economy, presents a potential obstacle to continued economic growth.

To fund World War II in the 1940s, the country ran up tremendous deficits and drove the size of the national debt to more than 100 percent of the gross domestic product (GDP). In the thirty years after 1945, the United States mostly balanced its budgets. As the economy grew in the post-war era, what was once a huge national debt was not paid down. However, it became an ever-smaller fraction of the total U.S. economy. Servicing the debt (i.e., paying the interest costs) became a smaller and smaller problem, until things began to change in the 1980s. At that time, a huge conflict existed within the Republican Party between "supply-siders," who said that deficits did not matter as long as economic growth was vibrant, and more traditional conservatives who felt that the nation should keep its debt in check just like a prudent business or household.

Yet, to some, the debts and deficits of the 1980s may now appear quite manageable, and the argument that the national debt was still only a modest fraction of the size of the economy, and necessary to deter Soviet expansionism, may seem plausible.

As long as the debt represented only 30, 40, or even 50 percent of the size of the GDP, one could argue that the United States resembled a homeowner carrying a mortgage in excess of his or her annual income or a business with outstanding debt no greater than 50 percent of annual profits. With the much larger national debt of the last few years, a hot new debate has once again arisen over the deficit.

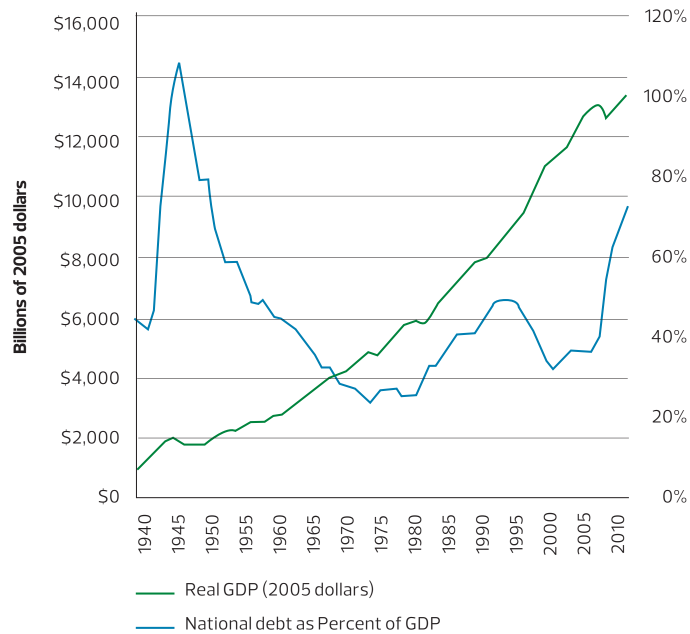
In 2010, two world-famous economists, Carmen Reinhart and Kenneth Rogoff, published a working paper, titled Growth in a Time of Debt, suggesting that there was a "red line" once a country's national debt exceeded 90 percent of its GDP. Many politicians, most of them conservatives, relied on the paper's conclusions to argue that the United States was spending too much, in large part on entitlements. In the last few weeks, other economists have pointed out a series of mathematical and other flaws in the original paper. As a result, some political liberals who want to avoid spending cuts in entitlement programs, unless accompanied by tax increases many conservatives are set to oppose, are claiming that there is no "red line." Echoing the supply-siders of the 1980s, some have even stated that deficits do not matter.

While few would disagree that the Great Recession caused a temporary jolt of deficit spending that will likely be reduced once the economy fully recovers, the real question is whether the United States will then still be on a path to run continuing deficits, for annual operating expenses, in the range of 60, 70, or 80 percent of GDP. After all, the annual interest on the national debt must also be paid and potentially added to the size of the debt itself if revenues (net of other spending) do not fully cover the debt service costs. Currently, the United States is in a period of historically low interest rates. What will happen if Treasury borrowing rates as low as 1 percent start to move towards 5 percent, which the Congressional Budget Office predicts will happen in only a few years? If deficits do not affect economic growth, even rising interest rates theoretically should not increase pressure for either spending cuts or tax increases. However, if the cost of servicing the debt begins to increase faster than the economy itself, the holders of U.S. debt may begin to fear the United States will never be able to repay it. While this would be another "red line" to worry about, the United States is not there yet.

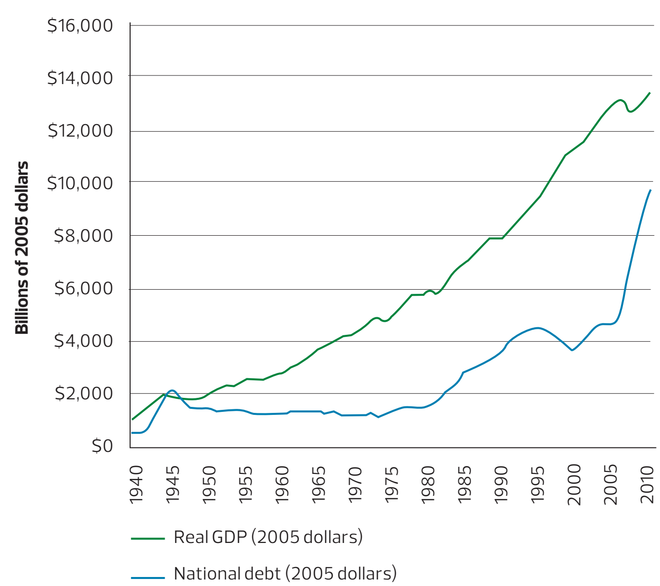
What about tax reform? Will all of the talk on this topic lead to any actual tax changes? The calls for "tax reform" on both sides of the aisle may be more about achieving the philosophical or economic policy goals of each side, with one side looking to curb deductions for upper-income taxpayers to promote more "equity" and the other side looking to lower tax rates to promote more "efficiency" or "growth," than about achieving true structural reform. Without a tiebreaker like deficit reduction (i.e., a common agreement that the deficit needs to be brought down for the common good), mere simplification of the tax code is unlikely to drive a political consensus.

Some economists have reputations for making a lot of assumptions and then making projections that are far too precise given the massive uncertainties they "assume" away. The below charts provide a common-sense perspective on this very technical policy debate.

The optimistic view on the national debt:
U.S. economic growth has seemingly been steady since 1940 without regard to the level of national debt as a percentage of GDP



The pessimistic or cautious view:
After decades of post-WWII balanced budgets the absolute level of our national debt is now approaching a point where it will equal or exceed the size of the total economy



The first chart reflects a "laissez faire" approach to the national debt. It shows that, since 1940, the national debt as a size of U.S. GDP has fluctuated dramatically as economic growth continued its steady march upwards. The chart shows the national debt rising quickly to over 90 percent of GDP just after World War II, decreasing to 30 percent in the doldrums of the late 1970s, increasing to 45 percent in the booming 1980s and 1990s, and now approaching 80 percent. The picture of continuing economic growth, even as deficits and debts increased and declined, could support the argument of those who say the size of the national debt doesn't really matter that much.

The second chart suggests a more cautious approach, like that of a prudent CFO managing a company's debt level in light of unavoidable economic uncertainties. The chart shows how the United States through economic growth in the post-war era was able to bring down the massive debt to GDP percentage that occurred suddenly during World War II. During this period, the United States mostly balanced its budgets and thus avoided adding to the national debt, which allowed economic growth to shrink the size of the World War II debts to a manageable size of the total economy.

Though in the 1980s the debt began to grow again as a percentage of the economy, it still appears to represent a manageable fraction of the economy. In this sense, the debt is not unlike a huge capital expenditure made by a growing business or a large mortgage of a young homeowner with expectations of growing income.

At the far right of the chart, however, the absolute level of debt may seem to be approaching a potentially dangerous level. Prudent business executives, and homeowners, recognize that constant revenue and profit growth is hard to sustain, even in the absence of financial emergencies. Thus, these parties often manage their debts under the assumptions that there may be an emergency (e.g., a leaky roof, lost job, recession, or bankruptcy of a major customer) and that too much debt limits the flexibility to deal with such emergencies.

Unfortunately, although many Washington politicians like to quote economists, action often occurs only in the wake of a crisis. If history is any guide, the issue of the size of the growing U.S. national debt is most likely to be addressed by Congress only when another economic crisis demands action or as a result of a major political shift that gives one side or the other control of both the Congress and the White House.

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