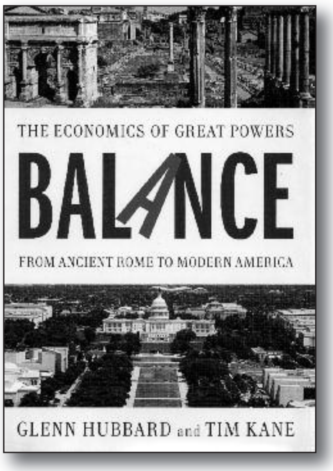
The Dangers of Debt: *A Layman's Guide*



An excerpt from

Balance: The Economics of Great Powers from Ancient Rome to Modern America

(Simon & Schuster, 2013)

by **Glenn Hubbard** *and* **Tim Kane**.

A new behavior of modern nations has emerged in the past few decades, unchecked by wise leadership or by international competition. Its symptom is the rising fiscal imbalance in nearly every advanced industrial economy, meaning annual deficits that accumulate into a pool of debt. The lowest recent level of U.S. debt held by the public relative to the size of the economy was 23.9 percent of GDP in 1974, which in real dollars was $344 billion. Today, the level is around 75 percent of GDP, or $11,578 billion (note: this figure does not include debt held in government accounts). By contrast, the European Central Bank reports that 2010 debt among member countries ranged from 119 percent of GDP in Italy to 143 percent in Greece and 6.6 percent in Estonia. Interest payment on higher debt levels is a major expenditure category that crowds out normal government functions if interest rates rise. That is, higher interest payments reduce governments' ability to fund defense research or education.

The U.S. debt level is alarming today because the pattern of ballooning budget deficits is occurring during *peacetime* (although two wars are winding down), an unprecedented departure from historical norms. Figure 1 shows the debt-to-GDP ratio over the course of constitutional history. Until the 1970s, the ratio generally declined during peacetime and spiked only during wartime. Five episodes of spiking debt established the norm—the Revolutionary War debt, Civil War debt, World War I debt, Great Depression debt, and World War II debt. Although the Great Depression debt spike was not caused by war, as the other episodes were, the pattern was similar—a sudden increase in annual fiscal deficits that approached 10 percent of GDP per year, followed by a gradual decline in total debt. Debt reduction occurred not because debt principal was paid down but rather because growth in the economy outpaced the debt. The outlier in America's debt episodes is the sixth one, in play since the middle of the 1970s. This episode is different in its features, neither sudden nor caused by a military crisis. We are not ignoring the wars in the Middle East during

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this era, but their total cost is a fraction of previous major wars. Besides, annual U.S. defense spending fell from 10 percent of GDP in the 1950s and 1960s to 6 percent in the 1970s and 1980s to 4 percent or less ever since.

What changed? Entitlement spending. In 1971, annual spending on Medicare and Medicaid was $11 billion, which was 1 percent of GDP. In 2010, those two programs cost $793 billion, or 5.5 percent of GDP. Add in Social Security and today these big three entitlements equal more than 10 percent of the nation's economic output. According to the Congressional Budget Office's (CBO) June 2011 Long-Term Budget Outlook, entitlement spending will grow to 15 percent of GDP over the next two decades. This spending along with interest payments on the debt and entitlement spending will absorb all expected tax revenue under current tax policy.

Figure 1. History of U.S. debt as a percentage of GDP

Source: Congressional Budget Office (2012).

TABLE 1. FEDERAL EXPENDITURES AS A PERCENTAGE OF GDP

	National defense	Social Security	Medicare	Health (Medicare)	Income Security
1940s	17.0	0.1		0.1	1.1
1950s	10.4	1.1		0.1	1.3
1960s	8.7	2.6	0.4	0.3	1.5
1970s	5.9	3.8	0.8	0.8	2.6
1980s	5.8	4.6	1.5	0.9	3.1
1990s	4.0	4.2	1.9	1.3	2.7
2000s	3.8	4.4	2.4	1.9	2.9
2010s	4.2	4.6	3.0	2.5	3.4

Source: Office of Management and Budget, 2013 budget, Table 3.1.

It wouldn't be wrong to call this scenario the entitlement bubble.

Entitlement implies a form of government spending to which all common citizens are guaranteed depending on circumstances, unlike discretionary spending, which can be lowered more easily (such as dollars budgeted for defense, highways, or space exploration). Table 1 shows how entitlement expenditures have grown in contrast to declining spending on defense. According to official records, two times more federal funds were spent on physical resources (energy and transportation) in 1943 and 1944 than on human resources (education, health, welfare, and all entitlement programs), a 2:1 ratio. In 1970, the ratio had reversed to 1:5. In 2000, the ratio had shifted further to 1:15, and in 2010 it was 1:27. Projections of how this ratio will crowd out infrastructure investments are easy to imagine.

The larger question then: *How* did this happen? The introduction of Medicare in 1965 and structural reforms to Social Security in 1972 made binding and growing expenditure commitments into the long-term future, beyond the horizon of political consequences. These entitlement promises, we can see clearly in retrospect, expanded beyond the obligations assumed by the creators of these programs. Promises of escalating future entitlements as the benefits were tweaked and excesses left in place have yielded obvious political payoffs as the years have gone by. Even now, after the results of the 2012 election are in, some of the first interviews of elected officials center on promises not to change the growth rates in entitlement programs. We are not talking about cuts. We are talking about slowing the growth of programs with technical adjustments, but this policy discussion is, to put it mildly, politically charged.

Unfortunately, the economy cannot outpace the entitlement problem through faster growth in the economy. As the CBO makes clear, "Without significant changes in government policy, [entitlement growth and medical cost inflation] will boost federal outlays sharply relative to GDP in coming decades under any plausible assumptions." Higher tax rates could be tried, but many Republicans and most Democrats misunderstand the limits of more taxation, which the CBO hints would likely create disincentives that have not been included in their forecasts. Despite the political dilemma, it is rare for any president or legislator to offer real, here-and-now cuts, let alone structural changes. The political process has neutered the legislative process in reacting to economic forces. ◆