EPI BRIEFING PAPER

ECONOMIC POLICY INSTITUTE • AUGUST 3, 2010 • BRIEFING PAPER #272

PUTTING PUBLIC DEBT IN CONTEXT

Historical and International Comparisons

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In the midst of the most severe recession since the Great Depression, large increases in the federal budget deficit were inevitable and remain necessary to address the jobs crisis. The United States must create more than 10 million jobs to move the unemployment rate back to even its undistinguished pre-recession level, and debt-financed public safety net spending and investment remain the most plausible way to enable this.

Today's policy makers, however, are extremely reluctant to pursue policies that would increase the deficit, even in the short-run. Opponents of providing more support to the job market often cite projections of the nation's public debt in the coming decade as reason to fear higher deficits. The Congressional Budget Office projects that this debt will exceed 80% of total gross domestic product (GDP) by 2020 if the Obama administration's policy plans are followed, while the Office of Management and Budget (OMB) projects that the debt will reach almost 70% of GDP by that year.[1] Under either scenario, national debt would be almost 20 percentage points higher than any year since 1955.

This Briefing Paper aims to answer the most fundamental questions raised by these projections: (1) *what has caused the rise in public debt;* and (2) *does this increase provide cause to worry about the future growth prospects of the American economy.* Its main findings are:

- The sudden *increase* in *public* debt is a direct and automatic response to the recession that was driven by the rapid *decrease* in *private* debt that followed the bursting of the housing bubble. A failure to accommodate the recession-induced decline in private debt with rising public debt would have resulted in a much harsher economic downturn.

- Debt levels relevant to the United States for the next couple of decades do not consign countries to subsequent stagnation and historically have been rapidly worked off.

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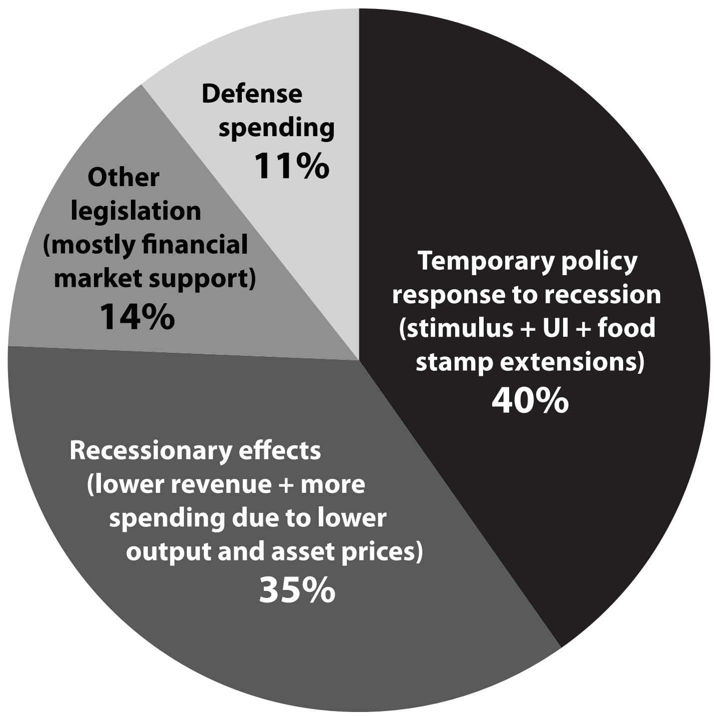
FIGURE A

Changes in FY 2010 budget deficit projections since March 2007



SOURCE: Authors' analysis of CBO data.

Origins of the rising public debt

The latest projections from the Office of Management and Budget (OMB) show that budgets proposed by the Administration will lead to the ratio of public debt to gross domestic product (GDP) rising from 36.2% in 2007 to almost 70% by 2020. This would be the sharpest rise in public debt since the World War II build-up.

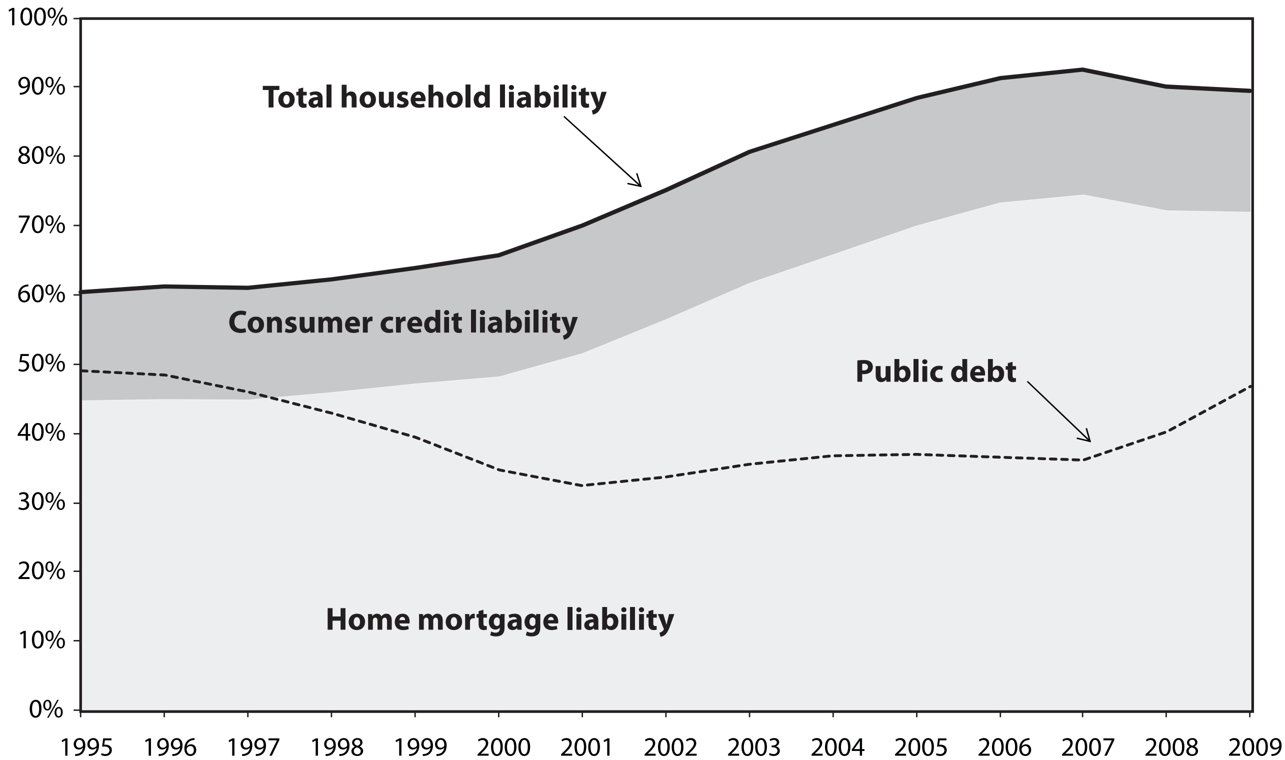
What explains this rapid rise in the deficit and public debt over this period? In short, the recession, and this severe economic downturn was a function of the rapid shedding of private-sector debt. **Figure A** shows the contribution of various factors to the current deficit. The automatic changes in spending and revenue due to the recession and the policy response to the recession were the largest factors in the increase in the deficit.

PUBLIC AND PRIVATE DEBT

Between 1995 and 2007, for example, the household sector in the United States saw its own debt to GDP ratio rise by (not coincidentally) over 30 percentage points, from 60.5% to 92.6% (shown in **Figure B**). Since then, the household sector has, in the jargon of economists, de-leveraged—decreased its debt levels. By the last quarter of 2009, the household debt-to-GDP ratio had fallen to 88.2%. In short, the public sector's projected debt increase is mirroring the private sector's debt decline.

FIGURE B

U.S. household debt versus public debt as a share of GDP, 1995-2009



SOURCE: Federal Reserve, OMB, and Bureau of Economic Analysis data.

Why did private-sector debt rise in the 1990s and 2000s?

The simple answer is asset market bubbles—both the stock market in the 1990s and the housing market in the 2000s. Both bubbles convinced too many households that they could meet long-run wealth targets (saving for retirement, putting kids through college) while still saving less out of current income. How? By relying on the capital gains earned from ever-appreciating stock and housing portfolios.

Today it is abundantly clear that this significant rise in private debt was unwise. However, it should be noted that economists and policy makers did very little to warn the public about any potential dangers. In fact, as late as 2003, with interest rates at historic lows, Federal Reserve Chairman Alan Greenspan urged potential homebuyers to take out adjustable-rate mortgages—mortgages often used to allow them to buy more-expensive homes than they would have been able to afford with traditional fixed-rate mortgages.

Why does declining private debt necessarily mean that public debt rises?

The decline in private debt simply means that households and businesses are spending less. And this decline in household and business spending is the recession. The decline in consumer and business spending has resulted in private-sector demand for goods and services that is insufficient to keep the American workforce fully employed.

In turn, the failing economy and soaring unemployment has almost *entirely* caused the sharp increase in public debt. The cratering economy caused taxes to fall and led to increases in safety net spending. Further, temporary policy actions aimed at softening the recession (the Recovery Act, the Troubled Asset Relief Program (TARP), and the nationalization of Fannie Mae and Freddie Mac) led to further deficit increases.

What does U.S. history teach us about projected public debt levels?

The projected increase in debt levels has effectively throttled attempts to use larger deficits to finance job creation measures—even as the unemployment rate in the United States has averaged just under 10% for much of the past half-year.

This retreat from job creation is unwarranted; a look at publicly held debt over time shows there is nothing about today's debt levels or debt levels projected a decade from now that should keep policy makers from addressing the jobs crisis.

Figure C shows U.S. debt held by the public as a percentage of GDP from 1940 through today and including OMB projections of public debt through 2020 (assuming the president's policies are enacted). In the aftermath of the Great Depression and World War II, U.S. public debt reached its highest recorded level in 1946, totaling 108.7% of GDP.

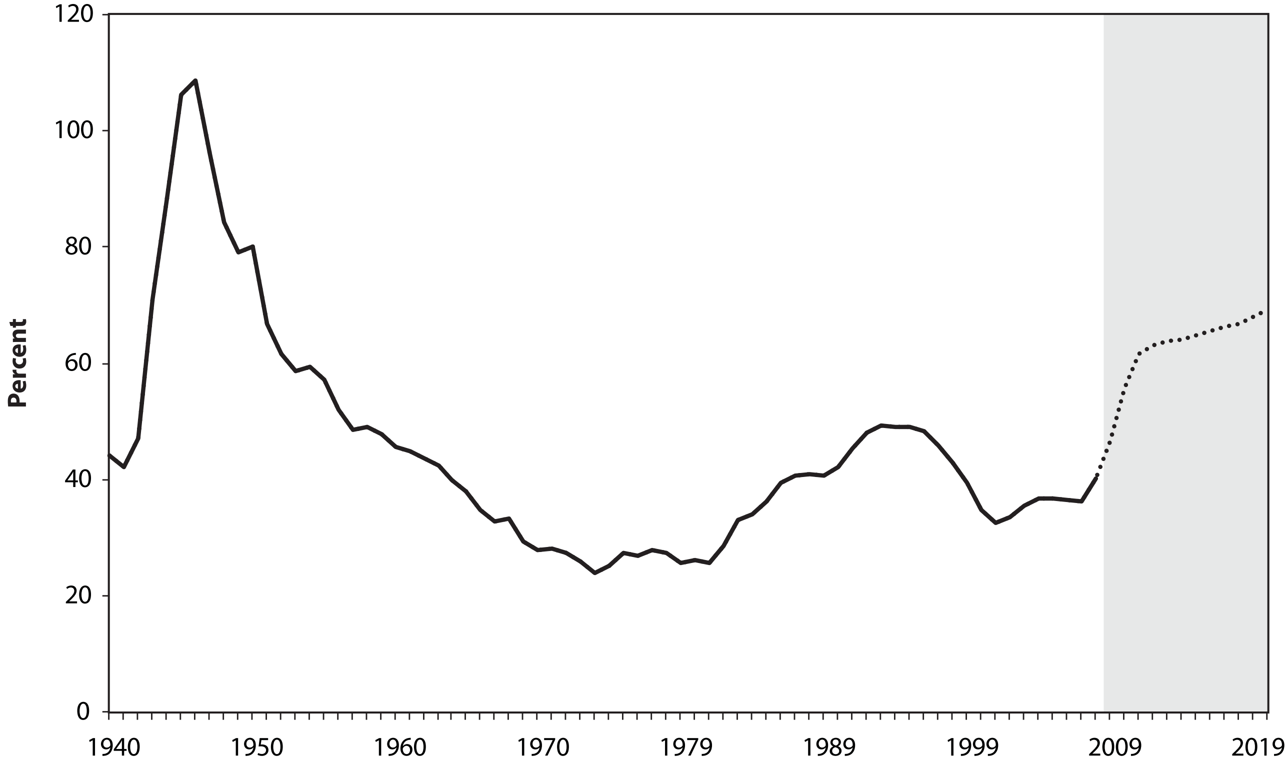
Did this debt level throttle growth for years to come? While the four years following 1946 saw the economy contract as the massive defense spending of the war was withdrawn, evidence over a longer-run does not show any slowdown. The overall economic growth rate between 1947 and 1973 was 3.8%, compared to 2.8% since 1973. By 1956, a decade after the highest debt level on record, as a result of the rapid economic growth and the winding down of war spending, the debt-to-GDP ratio had plummeted by 56 percentage points. It continued falling into the 1960s and the mid-1970s, bottoming out at 23.9% of GDP in 1974.

A similar, if far less extreme, story can be told about the more recent high point in the debt-to-GDP ratio, reached in 1993. This debt level was the result of large budget deficits (spurred by tax cuts for the well-off and a large increase in defense spending) that were run throughout the economic expansion of the 1980s as well as fallout from the recession of the early 1990s. By 1993, the debt had reached 49.3% of GDP (roughly the level of 2008). Again, was this level of debt injurious to future growth prospects? Not at all—fueled by policy changes (mostly tax increases) enacted in 1990 and 1993 *and* rapid economic growth, debt as a share of GDP dropped by more than 16 percentage points (or roughly a third) just in the eight years between 1993 and 2001.

These episodes in U.S. history suggest that there is little to fear when simply looking at current *levels* of public debt. There are, of course, always important questions to be asked about the policies that add to the debt. For example, was it wise for the country to add to debt loads during the economic expansions of the 1980s and 2000s, largely to provide tax cuts to the well-off?

FIGURE C

Public debt as a percentage of GDP, 1940-2020



NOTE: Shaded area indicates estimation.

SOURCE: OMB data.

However, given that today's debt is both a result of and a useful salve for the worst recession in years, there is little reason to consider this debt anything but inevitable as well as crucial to the future health of the economy. Taking these points together, there is no reason to sacrifice strong, debt-fueled action that addresses the jobs crisis for fiscal tightening anytime soon.

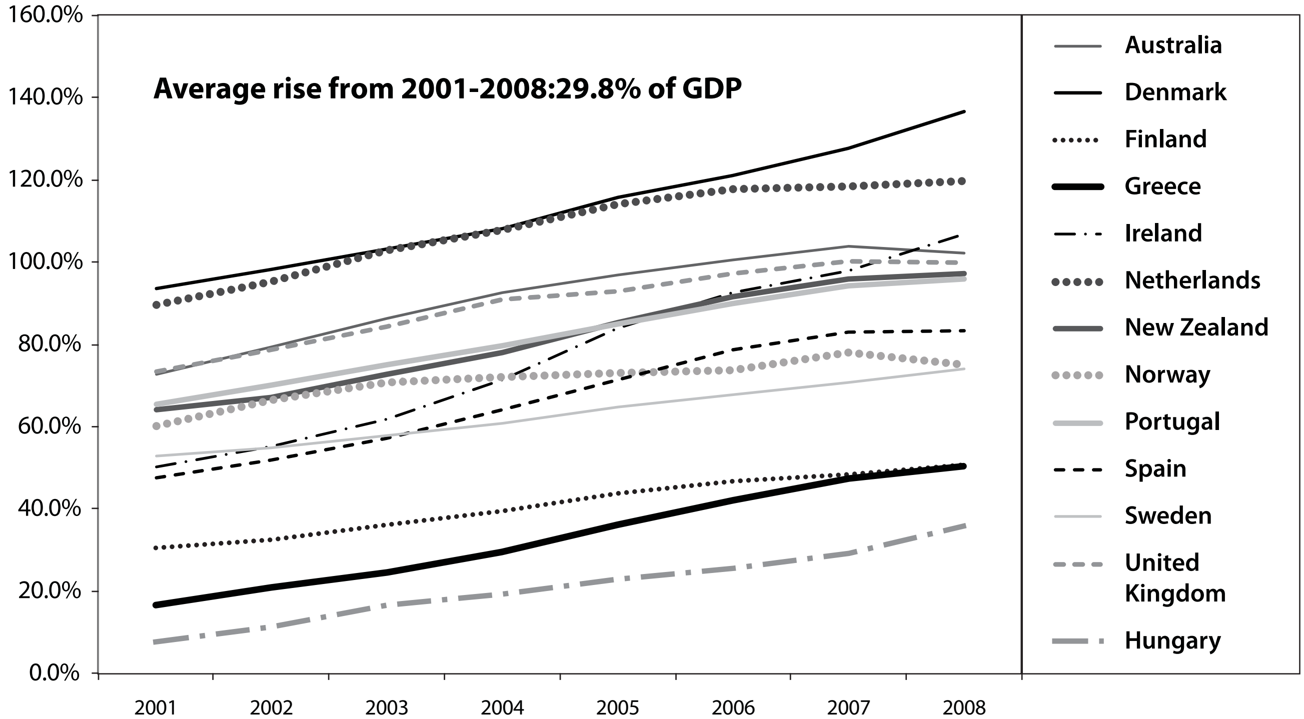
Is the United States an outlier? International experience with debt

Some have argued that the U.S. economy earlier this century was so large relative to the global economy that it could flout rules of prudential policy without paying a cost.[2] Now that there are potential competitor currencies to the dollar (although the Euro is looking shakier all the time), the argument runs that the United States will have to start respecting the same rules of the game as other countries.

However, the U.S. debt experience is actually *not* exceptional relative to its global peers. The household debt to GDP ratio rose startlingly fast in almost all Organization for Economic Cooperation and Development (OECD) nations from 1995 until 2007, and public debt has risen sharply in each since then (see **Figure D**).

FIGURE D

Private debt balloons across the economy: Household loans as a share of GDP



SOURCE: OECD data.

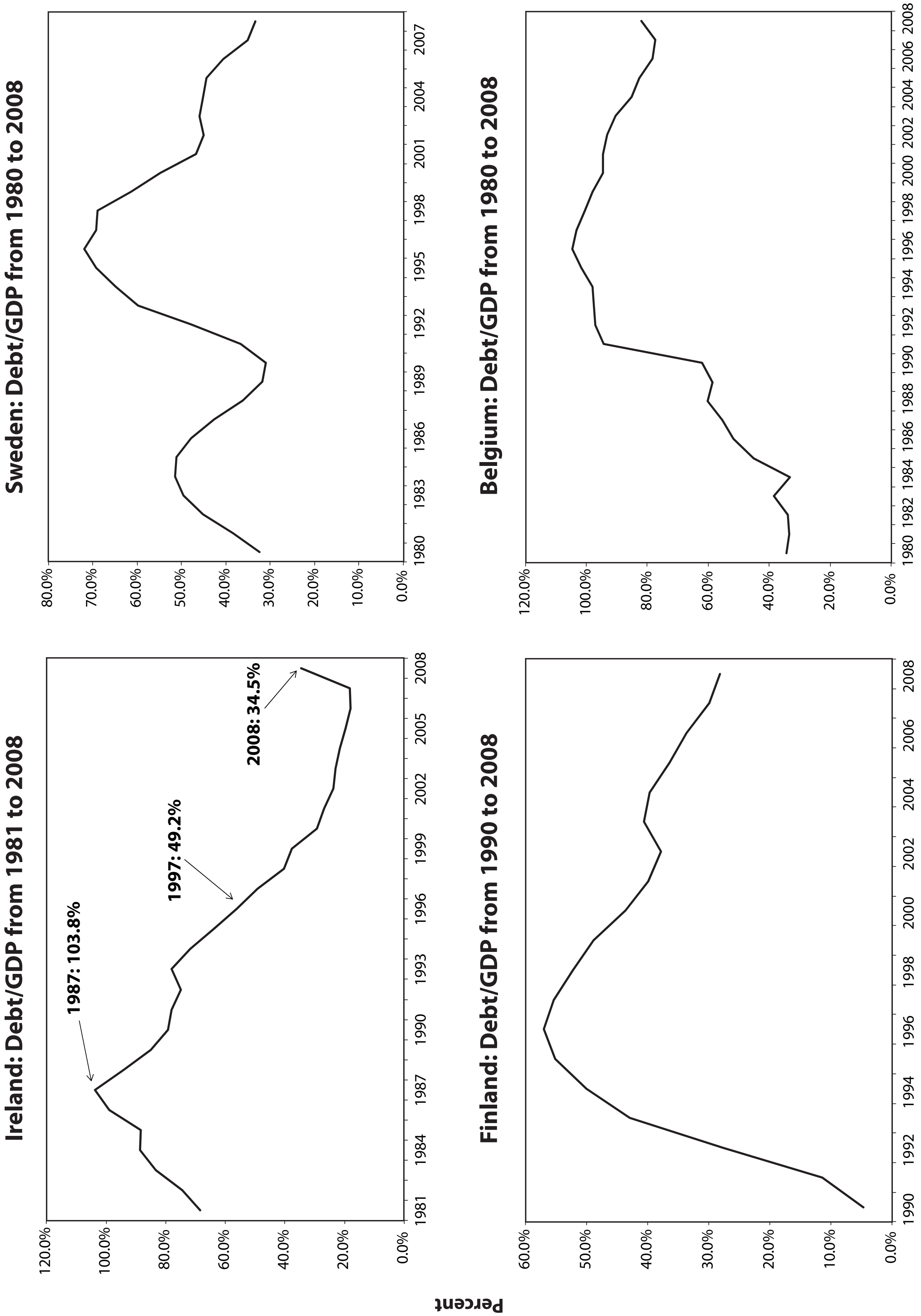
Many countries have experienced extremely high debt-to-GDP ratios in their history but have subsequently reduced them rapidly. **Figure E** shows some representative samples of this rapid recovery, tracking Ireland, Belgium, Finland, and Sweden as their public debt swelled rapidly in the wake of the (much steeper in Europe) recession of the early 1990s while falling almost as rapidly thereafter.

Sweden's debt peaked at 72% of GDP in 1996 but had fallen almost in half to 40.7% 10 years later. Ireland's debt peaked at 103.8% of GDP in 1987, yet was in half in the following decade. Belgium's debt peaked at 104.8% of GDP in 1996, but had fallen by 20 percentage points a decade later.

And these four countries are not outliers. Since 1980 when OECD debt-GDP data became available, at least 16 countries have experienced a fall in their debt-to-GDP ratio of at least 10 percentage points within a decade. Of those countries, nine have experienced a fall in debt of at least 20 percentage points within a decade, some of them falling much more rapidly.

Lastly, it is useful to note that current levels of U.S. public debt remain low by OECD standards and that the United States generally has low debt loads relative to its global peer group (see **Figure F**). Given that this peer group has actually seen higher rates of economic growth in recent decades than the United States, it seems hard to argue that debt loads like those experienced by the United States hinder growth.

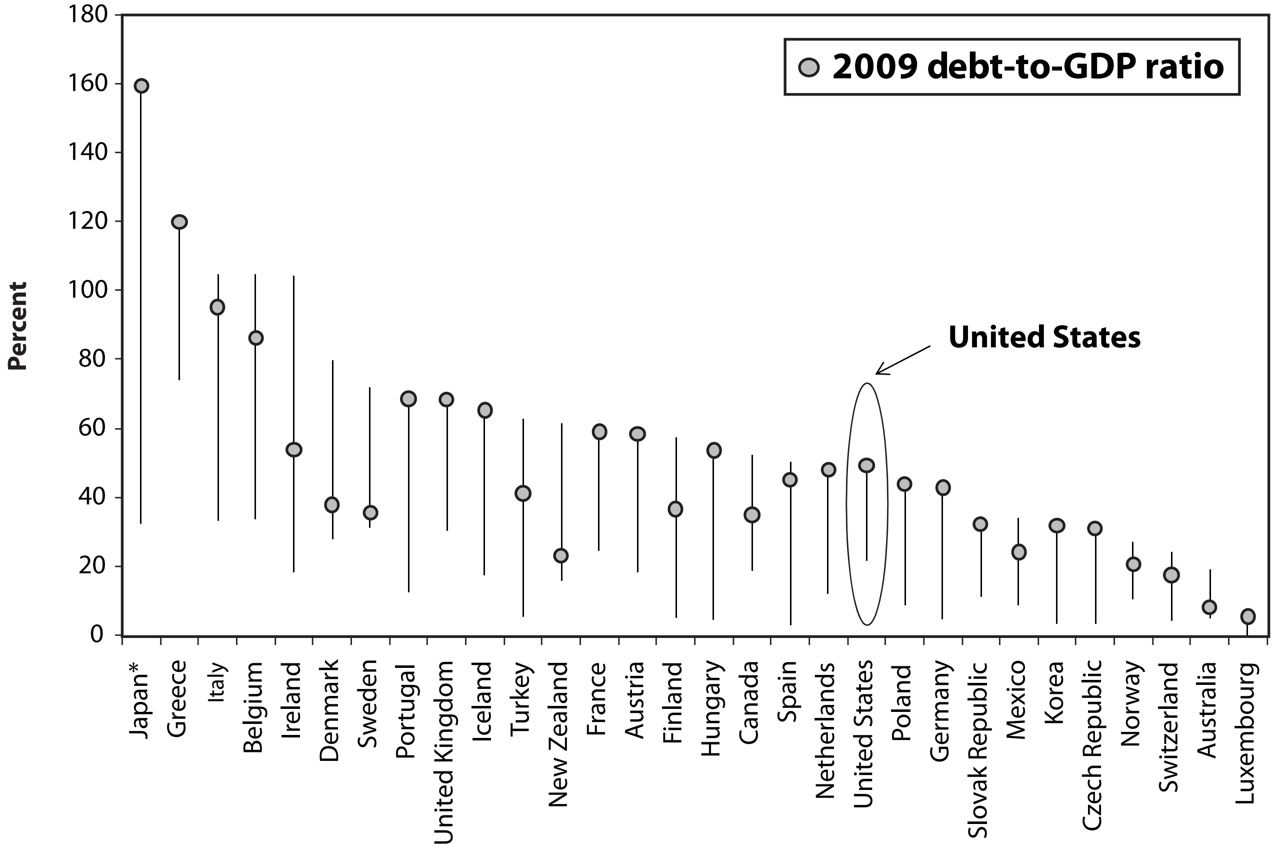
FIGURE E



SOURCE: OECD data.

FIGURE F

Debt-to-GDP ratio range, 1980-2009



* Japan's debt-to-GDP ratio is for 2008.

SOURCE: OECD data.

Conclusion

This quick survey of the debt experience of advanced countries provides further evidence that brushing up against historically high levels of debt does not scar economies' ability to generate growth in the future. Although recent research claiming the opposite has recently gathered wide notice (see Irons and Bivens (2010) for more on this research), it seems clear just looking at the summary data provided in this paper that a clear causality running from high levels of debt to hamstrung future growth is hard to sustain. High levels of public debt often are achieved *mechanically* when private debt contracts and the overall economy slows as a result; when growth begins again (often with the help of rising public debts that finance public safety net supports and investments) the debt-to-GDP ratios often retreat quickly.

It may have been more desirable to enter the Great Recession with a lower debt-to-GDP ratio so that job-creation efforts did not push these debt loads anywhere near previous historical high-water marks, but that is water under the bridge. Given the choices in front of us, the dangers of tolerating extremely high unemployment for years to come are much larger than adding to public debt to finance job creation in the short-run.

Endnotes

1. These numbers are a bit different from what is commonly reported by these agencies—the ratio of debt held by the public to GDP. The difference is that the number on debt held by the public includes public debt that was issued in order to acquire financial assets—assets that could be sold and the proceeds used to retire debt. The Office of Management and Budget (OMB) reports that publicly held debt net of these financial assets will be 69.3% of GDP in 2020, or roughly 7 percentage points lower than the gross debt. Given that this seems a better measure of potential burden of future debt, it is the measure we use in the paper. While the Congressional Budget Office does not present this figure, there is little reason to think that the value of financial assets will be much different from that what OMB estimates. For the remainder of the paper, debt figures for 2009 and onward using OMB data report this figure on publicly held debt net of financial assets. For figures relying on international data, this figure is not available, so the simple debt held by public data is used.

2. For example Buiter, Willem. 2009. Can the U.S. economy afford a Keynesian stimulus? *Financial Times.* January 5.

References

Irons, John, and Josh Bivens. 2010. "Government Debt and Economic Growth: Overreaching Claims of Debt 'Threshold' Suffer from Theoretical and Empirical Flaws." Briefing Paper #271. Washington , D.C.: Economic Policy Institute.