ECONOMY AND ECOLOGY 16.09.2024 | Dean Baker

Debt paper tiger

The US national debt is the highest it has been since the Second World War. And still, there is no reason to worry

The national debt in the United States has been rising rapidly ever since the tax cuts in the first year of the Trump presidency. The growth accelerated sharply with the pandemic relief and recovery packages and continues even now with the economy stabilised, as a high interest burden leads to large deficits. The publicly held debt already exceeds GDP and, according to the most recent projections from the Congressional Budget Office (CBO), will exceed peaks hit after World War II by the end of its 10-year budget horizon.

This story is often told as the basis for large-scale austerity, requiring a package of large spending cuts coupled with big tax increases. While it would be desirable to have smaller budget deficits, and, most importantly, a lower interest burden, there is little reason for the fear that many budget hawks try to instil.

Hardly any evidence for gloomy theories

First, there seems little basis in reality for the classic story of why large budget deficits are bad. This story holds that large budget deficits push up interest rates and crowd out private investment, thereby slowing growth and making us less rich in the future.

There have been endless studies of this issue and most find relatively little impact along these lines. At the most simple level, the current interest rate on 10-year Treasury bonds is a bit under 4 per cent. If we go back to the late 1990s when the budget was in surplus, there were brief periods where the rate fell below 5 per cent, but it was mostly close to 6 per cent.

And the higher current inflation means the difference in real interest rates is even larger. The real long-term rate (the nominal rate minus the inflation rate) when we had budget surpluses in the late 1990s was a full percentage point or more above the real rates we are seeing today. It's hard to tell the crowding out story if interest rates remain low despite the

large deficits. It's also worth noting that interest payments, measured as a share of GDP, are only slightly higher than in the early 1990s.

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There is also the crisis story, whereby we should fear a sudden flight from US debt and the dollar if we cross some debt threshold. Anything is of course possible, but there seems little basis for such fears in reality.

Other countries, notably Italy and Japan, have considerably larger debt-to-GDP ratios than the United States and still find plenty of buyers for their debt. Furthermore, the dollar's status as the world's preeminent reserve currency should make it even less likely that there will be some sudden flight from the dollar.

As long as the US economy remains strong, there should be little reason to fear a sudden dollar panic. If the economy were to become mired in stagnation or face some disaster associated with civil unrest or climate catastrophe, then we could see a mass flight from the dollar, but that would be the case even if the debt were half as large as its current level.

Limited prospects for reducing the deficit

Even if we were concerned about the debt, the prospects for substantially reducing deficits are limited. On the revenue side, there is very little support for any tax increase that hits the middle class.

There is political support for taking back some or all of the recent tax cuts to wealthy individuals and corporations. The Trump tax cuts in 2017 reduced the top marginal tax rate from 39.6 per cent to 37.0 per cent. This part of the tax cut is actually set to expire next year and may not be renewed, depending on the outcome of the fall elections. (The budget projections already assume that this tax cut will not be extended.)

There is, in principle, room to raise the rate further, although many progressives exaggerate this space. Many states have imposed high tax rates on wealthy residents, with California topping the list at 13 per cent, followed by an 11 per cent rate for residents of New York City. With many of the country's richest citizens already facing tax rates of more than 50 per cent, the amount of revenue gained by pushing rates much higher will be limited.

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the corporate side. The CBO projections show revenue from the corporate income tax falling to just 1.3 per cent of GDP. By contrast, it was well over 2 per cent of GDP as recently as the 1990s and had been well over 3 per cent of GDP in the sixties.

Reversing this decline can substantially reduce the deficit. However, it is important to recognise that a high corporate tax rate does not mean high corporate taxes. They have become experts at gaming the tax code. Prior to the Trump tax cuts, the nominal corporate tax rate was 35 per cent, but the actual tax rate was just over 20 per cent.

Any effort to boost corporate taxes should focus on taxing stock returns (dividends and capital gains), which can be readily found on any financial website. By contrast, corporate accountants tell the government what corporate profits are. The Biden administration made a small step in this direction with a 1 per cent tax on share buybacks. This will require very few enforcement resources since companies have to publicly disclose how much money they are spending on share buybacks.

Possibilities for substantial savings

On the spending side, it is difficult to envision large cuts since most areas either involve little spending or have substantial political support. The military, Social Security, Medicare and other health care programs take up over 70 per cent of non-interest spending. The remaining 30 per cent has already been hacked at repeatedly in prior efforts at deficit reduction.

The one place where substantial savings are possible is with healthcare. The US has the most inefficient healthcare system in the world, paying more than twice as much per person as the OECD average. We have already seen substantial savings compared to prior cost-growth projections.

In 2011, CBO projected the federal government would spend 7.4 per cent of GDP on Medicare and other healthcare programs. Instead, we are spending just 5.6 per cent of GDP. Given how excessive our spending remains, we can achieve further savings.

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The most obvious place to look is reducing what we pay for prescription drugs. We will spend over $650 billion this year (2.3 per cent of GDP) on prescription drugs and other

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pharmaceutical products. The US pays more than twice as much for these items as people in other wealthy countries. By getting our payments more in line, we can achieve substantial savings in the budget and for patients in out-of-pocket expenses.

It's also worth noting that the high payments here are almost entirely due to government-granted patent monopolies. In a free market, drugs would almost always be cheap. It is the patents that make them expensive. Interestingly, while there is a major lobby that complains about the interest burden we impose on our children, almost no one ever mentions the burden created by government-granted patent monopolies.

Ultimately, if we think of what we pass on to future generations, the national debt is a trivial part of the picture. If we paid off the debt entirely but left the economy in ruins by neglecting education and infrastructure or stifled growth with excessive austerity, or wrecked the planet by ignoring global warming, our kids would have no reason to thank us.



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