Does the Debt Matter?

Peter Wehner and Ian Tufts

Since the earliest days of the American republic, political leaders have been concerned about the threat posed by large deficits and mounting federal debt.

In a 1790 letter to Henry Lee, James Madison wrote that “as far as this object will permit I go on the principle that a Public Debt is a Public curse and in a Rep. Govt. a greater than in any other.” Thomas Jefferson, who entered the White House facing a large government debt due to the Revolutionary War effort, promised to pay down a substantial part of that debt—and did. Writing in retirement, he told his close friend and fellow Virginian John Taylor that “the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale.” Decades later, Abraham Lincoln, at a Whig Party meeting in Springfield, Illinois, warned that government debt “is a system, not only ruinous while it lasts, but one that must soon fail and leave us destitute.”

This anti-debt ethos was overtaken for much of the 20th century by Keynesian economics, which suggested that deficit spending, particularly in down times, was good for the economy. But by the end of that century, presidents of both parties—including Jimmy Carter, Ronald Reagan, George H. W. Bush, and Bill Clinton—expressed concerns about growing deficits and debt. Reagan warned against leaving our children an “un-repayable massive debt and a shattered economy”; Bush described budget deficits as a “cancer”; and Clinton declared that “without deficit reduction, we can’t have sustained economic growth.” While each of these presidents

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promised to balance the budget, most failed to do so; only Clinton managed to accomplish it on his watch, and only for a brief moment.

In issuing their warnings, these presidents echoed mainstream economists, budget directors, chairmen of the Federal Reserve, and influential figures in the world of finance—both Democratic and Republican—who sounded the alarm about the potential consequences of a dramatic fiscal imbalance. These experts warned that large annual deficits and debt could lead to troubling, even catastrophic, consequences: prolonged recessions, rising interest rates, increasing inflation, reduced upward mobility, a weakened dollar, a plunging stock market, a mass sell-off of foreign-government holdings of U.S. Treasuries, a collapse of the financial system, and general economic and social calamity. These would all grow more likely, they cautioned, if the federal government failed to get its fiscal house in order.

A curious thing has occurred in recent years, however. Prior to the coronavirus pandemic (which is delivering a brutal blow to the American economy on its own), the United States was experiencing historically low unemployment, inflation, and interest rates, as well as the longest-running economic expansion in history, all despite having reached record annual deficits of more than $1 trillion and a national debt of more than $20 trillion. It appears the day of reckoning was not nearly as close as many people imagined.

So why haven’t the predictions of debt-induced economic ruin—the warnings that we were on the cusp of a debt crisis similar to the one that befell the Greek economy in 2009—been realized? Why were economic indicators doing so well despite our staggering national deficits and debt, at least before the coronavirus pandemic reached our country? Has this century proved the deficit worrywarts wrong?

Those who fear an impending economic collapse offer several possible explanations of why a debt crisis has not yet come to pass. Perhaps the fact that the U.S. government can print as many dollars as it needs means that it can never really default on its debt, as some on the left now argue. Perhaps the particular circumstances of the 21st-century global economy make an immediate debt crisis much less likely. Maybe America’s unique role as a safe haven for investment during global economic downturns provides a guardrail against financial collapse.

Or maybe the trouble has simply taken longer to come than some who expressed grave concerns imagined. The U.S. government is swiftly
adding trillions of dollars to the debt this year to address the pandemic and the economic devastation our response has triggered. If there is a debt disaster looming in our future, the novel coronavirus has surely brought us that much closer to it. Indeed, it may offer a test of the case for more general anxiety about the debt.

Looking over the case for concern, as well as the counterargument that we just shouldn’t worry about the debt, leaves us with reason to worry. The notion that mounting debt would yield a sudden, catastrophic crisis does not seem to have been well grounded in contemporary economic realities. Yet the idea that this mounting debt is no trouble at all is awfully implausible, too. The truth may be more challenging than either of those options for our weary and polarized political system.

Massive debt is surely a real problem. But rather than a sudden, Greek-style economic implosion, in the United States, it likely poses the threat of a gradual and incremental weakening of economic potential. Such a threat stands less chance of attracting the attention of the body politic, which these days cannot seem to take anything seriously unless it’s presented as an impending crisis. Taking the debt seriously—neither panicking nor falling into denial—will require a mature concern for the future.

**Debt Without End?**

When Jonathan Rauch wrote an *Atlantic* essay entitled “Is the Deficit Really So Bad?” in 1989, ominous warnings were being made about the U.S. fiscal imbalance, which was far less severe than it is now. (The national debt at the time was $2.85 trillion, deficits were between $150 billion and $200 billion per year, and the ratio of debt to gross domestic product (GDP) was just under half of what it is today.) “Something terrible may yet happen,” Rauch observed, “but with each year in which it does not, the case for regarding the budget deficit as an economic crisis weakens.” He continued: “The credibility of the deficits-are-disastrous school is shot, which leaves everybody wondering what it is, after all, that we are so worked up about.”

The reason many would give for being so worked up about consistently high deficits and debt is, at least in part, historical precedent. “Imperial falls are associated with fiscal crises,” notes Harvard historian Niall Ferguson. Indeed, as Ferguson points out, the imbalances between
revenues and expenditures, and the enormous cost of servicing a mountain of public debt, brought other nations— including 17th-century Spain, 18th-century France, and 20th-century Britain—to their knees. It could easily do the same to the United States.

One doesn’t have to look to the distant past to find other examples. Southern Methodist University’s J. H. Cullum Clark points out that Japan “has paid a considerable price for its extravagant past spending and borrowing” in the last few decades, and that “living standards in more frugal Singapore, Taiwan, and South Korea have either surpassed or will soon surpass Japanese levels.” Likewise, “Italy achieved extraordinary growth from the 1950s to the 1970s but then went on a spending binge and became one of the world’s most indebted countries.” The results were similarly disappointing for the Italians, Clark notes: “Italy’s experience provides further evidence of crowd-out in its educational attainment, business investment, and growth since the 1990s—all among the lowest in Europe.”

In an influential 2010 article in the *American Economic Review*, Carmen Reinhart and Kenneth Rogoff explored the relationship between growth, inflation, and levels of public debt based on data for 44 countries during a 200-year period. “Over the past two centuries,” they wrote, “debt in excess of 90 percent has typically been associated with mean growth of 1.7 percent versus 3.7 percent when debt is low (under 30 percent of GDP), and compared with growth rates of over 3 percent for the two middle categories (debt between 30 and 90 percent of GDP).” For comparison, the latest projection from the Congressional Budget Office (CBO) is that the U.S. federal debt will amount to 101% of GDP by the end of fiscal year 2020. At the end of fiscal year 2019, the debt was 79% of GDP. The CBO also predicts that for fiscal year 2020, the budget deficit will soar to a record-smashing $3.7 trillion.

Many of those who worry about how massive deficits and debt have affected countries in the past say that the United States is not immune—that unchecked deficits and debt will eventually undermine creditor confidence in America and could catalyze a massive sell-off by non-American holders of U.S. Treasury debt. This could dethrone the dollar as the world’s primary reserve currency, push up interest rates and inflation, and crowd out private investment, thereby reducing future incomes and wages. A multi-trillion-dollar debt reduces our “fiscal space” to take aggressive action when facing a future crisis, to say nothing of
the increased burden it places on future generations, as any efforts to tame the debt will likely result in huge tax increases and draconian spending cuts.

Even if you accept all of these arguments—and we find some of them persuasive and some of them less so—we still come back to the central question: Why has the American economy, at least based on some key indicators, thrived even as we have set deficit and debt records year after year, decade after decade?

One explanation is offered by so-called modern monetary theory (MMT), the hot macroeconomic theory among progressives. And in the last year, MMT has become a topic of much discussion in the world of professional economists.

MMT advocates believe governments that issue their own currency—and particularly a government whose currency serves as the world’s reserve currency of choice—can essentially borrow without limit. No matter how large the federal debt grows, the federal government can always print more money to pay for it. Breaking with conventional economic theories, MMT advocates argue that doing so imposes almost no serious costs or risks.

One of the practical effects of MMT is that its proponents don’t believe that budget deficits and the rising debt have to be paid for by spending cuts or tax increases. In most cases it’s fine to live with deficits and debt, MMT advocates argue, and in some ways it’s good to live with them, since federal spending and deficits produce surpluses in other parts of the economy. Stephanie Kelton, author of *The Deficit Myth: Modern Monetary Theory and the Birth of the People’s Economy*, captures the attitude of the MMT crowd toward deficit spending when she urges political leaders to “acknowledge that the deficit itself could be deployed as a potent weapon in the fights against inequality, poverty and economic stagnation.” According to those who hold this view, deficits and the debt matter a whole lot less than we’ve been led to believe, and the predicted economic catastrophe that is always just around the corner will never really materialize.

But their case quickly gets murky. Those who embrace MMT concede that at some point, there arise dangers attendant to too much spending. U.S. Representative Alexandria Ocasio-Cortez, a prominent progressive and an advocate of MMT, admits that when lawmakers “decide to go into the realm of deficit spending, [they] have to do so responsibly.”
Kelton, too, acknowledges that the “federal government could try to spend too much into an economy that doesn’t have the room to absorb that much new spending. And you begin to get an inflation problem.”

MMT challenges the commonly held view that a high rate of money creation is in itself inflationary. The MMT view, according to Harvard economics professor Gregory Mankiw, is that “inflation gets out of control when workers and capitalists each struggle to claim a larger share of national income.” For champions of MMT, then, inflation occurs when there are not enough resources in the economy to soak up the money in the system. In that case, MMT advocates concede that it might be necessary to raise taxes to drain some of the money out of the economy. For that reason, Mankiw adds, “incomes policies, such as government guidelines for wages and prices, are a solution to high inflation” under MMT.

MMT has generated no shortage of criticism from mainstream economists. When the University of Chicago’s Initiative on Global Markets polled its Economic Experts Panel, there was unanimous rejection of core tenets of MMT. Mankiw offered MMT advocates some concessions, saying that he found “some common ground with [MMT] proponents without drawing all the radical inferences they do.” He then continued: “I agree that the government can always print money to pay its bills. But that fact does not free the government from its intertemporal budget constraint.”

Harvard’s Kenneth Rogoff, a skeptic of MMT, is less deferential:

The U.S. is lucky that it can issue debt in dollars, but the printing press is not a panacea. If investors become more reluctant to hold a country’s debt, they probably will not be too thrilled about holding its currency, either. If that country tries to dump a lot of it on the market, inflation will result.

Similarly, in Senate testimony last year, Fed chairman Jerome Powell expressed concern about rising U.S. debt, adding that “the idea that deficits don’t matter for countries that can borrow in their own currency I think is just wrong.”

These criticisms of MMT are persuasive to us. The fact that a sovereign government with a fiat currency can “print money” to its heart’s content doesn’t mean that there will be no adverse effects from doing so. But the unrealized predictions about the calamitous effects caused by
past deficits and debt create an opening for a new theory. After all, *something* has to explain the gap between the rhetoric and the reality—the breach between what was predicted and what has since transpired.

**BETWEEN DOOMSAYING AND DEBUNKING**

The confidence with which MMT advocates assure policymakers that they need not worry about debt is part of what makes traditional economists uneasy. But the same kind of confidence is surely part of what was wrong with the case for worrying about debt in the last several decades. Circumstances matter, and theory must arise from empirical reality rather than being imposed upon it.

For instance, those who, in the wake of the Greek debt crisis that began in 2009, anticipated that the United States would soon follow suit did not sufficiently account for the significant differences between the two countries’ economic circumstances. These include the fact that the American economy is far larger and more diverse than the Greek economy, that Greece’s debt was held mostly by foreigners, and that the dollar, unlike the euro, is the world’s reserve currency. Moreover, the United States controls its own currency, meaning it can pay its own debt. Greece, as part of a currency union consisting of 17 nations at the time, could not have done the same.

These features of the American economy combine to form what economist Andrew Steer calls an “automatic hedging mechanism.” As he explains:

> It’s important to understand the special privileges that the U.S. enjoys due to its economic status—not just in that the rest of the world wants to hold dollar-denominated assets, but that the demand for them *increases* the more risky the world becomes…. The reason that most countries have to watch their deficit and debt numbers is because, in the event of a shock, demand for their debt may fall sharply. For the U.S., demand for a “safe haven” rises, and money flows in the riskier the world becomes.

It appears, then, that America’s unique economic status has helped shield it from the risks of running high deficits and accumulating debt. Deficit hawks who predicted disaster also made several mistaken assumptions. As Stuart Butler, a Brookings Institution senior fellow in
eonomic studies, puts it, those who predicted imminent economic collapse “were not correct about monetary policy and interest rates.” Deficits and debt, he explains, “have not led to interest-rate-driven debt acceleration as we’d expected, and that allowed debt to grow without unduly slowing growth.”

Butler adds that fiscal-cliff prognosticators were likely wrong about the manner in which the damage would be done: “Falling off a cliff,” he notes, “is not the scenario.” Instead, the effect of debt and deficits “is more gradual, with an incremental erosion of prospects and opportunity for future generations.”

Michael Strain, director of economic policy studies at the American Enterprise Institute, offers a similar assessment, noting that “critics of large deficits have overplayed their hand by focusing on the risk of a true, Greece-style debt crisis.”

“Debt is more of a termites-eating-the-woodwork problem than something that produces an immediate, one-time crisis,” Strain continues, “but it is a problem nonetheless.”

Other factors should have been taken into account by observers but weren’t. Jonathan Rauch of Brookings points out that the United States has moved from an inflationary environment to a disinflationary environment, with the result being that deficits are more sustainable, and even beneficial, in moderation. Foreigners, he notes, have shown a larger-than-expected desire to hold U.S. government debt as a store of wealth and as financial collateral. In addition, interest rates have been very low by historical standards, thus greatly reducing the burden of borrowing.

Those warning about a debt-driven fiscal calamity may also have looked at deficits and the debt in isolation rather than compared to our total assets (more than $128 trillion) or the size of the American economy. According to Robert Beschel, Jr., a senior fellow with the Brookings Doha Center who was formerly with the World Bank:

Those who have historically worried about the debt have framed it in aggregate terms—like the famous deficit clock. But the key question is not the aggregate size of the debt or the deficit, but its size in relation to the economy and the ability of a given country to service it. A trillion-dollar deficit is a scary number, but not as scary if you realize that it’s only around 4.6% of the $21.5 trillion U.S. economy.
What’s more, according to Christopher Smart, former deputy assistant secretary of the Treasury in the Obama administration, America still has a better “economic model, financial markets, and legal infrastructure than all of the alternatives.” This means that America still delivers better economic growth and more innovation than developed-market alternatives such as Europe or Japan, while China and other emerging markets remain too risky. The United States also has the world’s deepest and most sophisticated financial markets, which makes dollar assets an attractive refuge in a crisis. In short, when foreign investors lend the United States money, they know they can always get it back. “When the going gets tough, as it did again in March,” Smart says, “people around the world believe their money is safest when invested in U.S. government securities.”

Smart also believes that long-term structural changes to the global economy are keeping inflation low despite rising debt and deficits. These changes include globalized markets, technological advances that have reduced production costs, weak labor unions, developed countries with increasingly older populations who tend to spend less, and expectations that prices won’t increase.

Falling short of a catastrophe, however, doesn’t mean that persistently high deficits are not harmful. According to Rauch, there’s evidence that substantial budget deficits drove up interest rates and trade deficits in the 1980s, while reducing deficits seems to have been economically beneficial in the 1990s. Running large, persistent deficits when the economy is strong can also tie the government’s fiscal hands when the economy is weak and obscure important budgetary choices about the nation’s priorities. Interest payments on the debt, which are now up to $1 billion per day and are the fastest-growing component in the federal budget, take money away from more productive purposes such as medical research and repairing our infrastructure.

Moreover, as Steer notes, America’s privileged economic role vis-à-vis the rest of the world is not guaranteed: The United States could “accelerate the loss of safe-haven status,” he says, through “a decade or two of what is perceived to be profligate behavior, accompanied by a retreat from global leadership, whether on pandemics, climate change, or global security.”

So while predictions about the ruinous effects of massive deficits and debt on the American economy haven’t panned out thus far, the debt is
also not without its serious costs. It would thus be a mistake to assume that everything we thought we knew about economics and deficits was wrong. And even if incremental increases in the debt over two decades have not sparked a crisis, can we be confident that a sudden, massive increase will be sustainable, too?

**The Costs of a Pandemic**

If the debt was a problem before, it has become exponentially worse since the coronavirus pandemic hit. Indeed, the pandemic is delivering a crushing blow to the American economy. The final cost is impossible to calculate at this stage, as there are many things we still don’t know — how long the pandemic will last, whether there will be a second wave, how long it will be before there are effective treatments and a vaccine, what effects a phased re-opening will have on an economic recovery, and more. But for now, some of the low-end estimates are that the combination of massive stimulus spending and a dramatic economic downturn will push the budget deficit in 2020 to $3.7 trillion, nearly 20% of GDP — the highest percentage since World War II. (Just before the outbreak, the CBO predicted the deficit would be 4.9% of GDP.) In fact, for the first time since that war, U.S. debt held by the public will be larger than what the country’s economy can produce in a given year.

Meanwhile, during the first quarter of 2020, the U.S. economy contracted at an annualized rate of nearly 5% — what was then the most dramatic decline since the Great Recession. The following quarter, the GDP shrank at an annual rate of 32.9%, amounting to the sharpest economic contraction in modern American history. The unemployment rate is likely to remain in double digits through the end of the year. As a result, the overwhelming majority of economists and politicians, including those considered to be fiscal conservatives, supported adding trillions of dollars in new debt in order to counteract the economic damage of Covid-19. This past spring, Congress approved $2.4 trillion in spending to combat the coronavirus recession — including the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which passed the Senate by a vote of 96-0 and will add to federal deficits by about $1.7 trillion over a decade. Another aid package is on the table this fall. “In different times we’ll fix the deficit,” Treasury Secretary Steven Mnuchin told reporters in March. “This is not the time to worry about it.”
U.S. lawmakers had no choice but to engage in record-smashing deficit spending, with the hope that doing so will make the recession of 2020 shorter and less severe than it otherwise would have been. But the consequences could still be serious. “We should be very worried,” warns Princeton University economics professor Atif Mian. “We are talking about a level of debt that would certainly be unprecedented in modern history or in history, period. We are definitely at a tipping point.”

Whether this proves to be the case remains to be seen. Right now, deflation is more of a threat than inflation, and interest rates will almost certainly remain low for the foreseeable future. At the same time, “debt is not free,” as a January 2020 working paper published by the International Monetary Fund put it. The four authors of the paper studied 188 countries going back to the 1980s, finding that “public debt in its various forms is the most important predictor of fiscal crises.”

Because the empirical evidence is inconclusive, lawmakers should have acted prudently by reducing the deficit and putting us on a sound fiscal path when the economy was strong rather than weak, when it was growing rather than in recession, when it was near full employment rather than setting post-Great Depression unemployment records. “One of the primary reasons to be fiscally responsible during periods of economic expansion is to have the capacity to fight downturns or emergencies,” Maya MacGuineas, president of the Committee for a Responsible Federal Budget, told Neil Irwin of the New York Times. “This is precisely the kind of moment, where borrowing is warranted and necessary, that we should have been preparing for over the past years.”

Both political parties bear some responsibility for this failure: Democrats for opposing cost-saving entitlement reforms and vilifying those who advocated them; Republicans for passing huge tax cuts without paying for them. But blame rests, too, with the American public, which tends to support deficit reductions in the abstract while opposing them in the real world.

The best way to think about the path forward is to pursue several interlocking approaches at the same time: continuing to pump trillions of dollars into the economy to keep it from collapsing; keeping interest rates near zero; continuing to promote open-ended quantitative easing to inject money into shaky financial markets; and putting in place spending policies that are temporary rather than permanent—one-offs rather than structural. “This is not permanently raising
“government spending,” says Louise Sheiner, who has served as an economist with the Board of Governors of the Federal Reserve System. “It’s a one-time thing. A big one-time thing, but it raises the level of debt and doesn’t do anything to the trajectory of debt after that, which makes it less challenging in the grand scheme of things.”

Even if that’s the case, and even if the deficit does revert to a more normal level in a few years, we’ll still find ourselves in a much deeper fiscal hole than we were in before the pandemic. The deficit and debt pile-up we’re facing now is of a whole different magnitude than ever before. It will surely offer a particularly clear and dangerous test of the proposition that massive amounts of debt can be sustained without devastating economic costs.

**Intergenerational Justice**

The risk involved in such a test will be borne by the rising generation. Indeed, an important consideration when thinking about debt is the matter of intergenerational justice—a concern that, as noted above, Thomas Jefferson articulated in the earliest years of the republic. As Beschel put it more recently:

> Government debt never just goes away—it gets rolled over into new debt instruments. Is it really fair to burden future generations with the debts that we have accumulated? At a period when social mobility is declining and the prospects for children exceeding their parents’ wealth and lifestyle are increasingly compromised, is it fair to ask them to pay off our debts as well?

As soon as it’s reasonable to do so, we need to begin to repair the immense fiscal imbalance we have wrought. Post-pandemic, this suggests the need to make a commitment to fiscal responsibility—a pledge to take unpleasant but essential steps that politicians on all sides have paid lip service to but have rarely put into practice. Everything needs to be on the table—entitlement reforms, a restructuring of the tax code (including tax increases), changes to the federal budget process, etc.—to ensure that the United States can gradually bring the public debt down to more sustainable and safer levels.

The nature of the American form of government—which involves checks and balances and the separation of powers—means that this
can’t be done unless there is a willingness to compromise on both sides, which is hardly commonplace these days. Yet there are past models we can look to and learn from: the 1983 Social Security agreement, the 1986 tax-reform agreement, the 1997 budget deal between Clinton and the Republican Congress. In each of these cases, one party controlled the presidency and the other controlled Congress. And in each instance, both sides forged an agreement with which all could live.

Yet when it comes to sweeping entitlement reform, deficit reduction, and taxes, it’s been a long time since anything substantial was agreed upon. That explains, in part, why deficits and the debt have skyrocketed. Unless we intercede to change their trajectory, the situation is going to get worse. And unexpected events—9/11, the 2008 financial crisis, the 2020 pandemic—that exacerbate the problem will inevitably intervene.

The question now is whether our fiscal situation is so grave, and the dangers posed by the massive costs of this crisis so apparent, that it creates opportunities for reform that until now have not existed. This depends in part on political leadership—on whether those in public life, most especially a future president, make this issue a priority. And, if they do, whether they can persuade the public to go along.

The American polity, too, has a role to play. Politicians are ultimately responsive to the determined will of their constituents. If Americans want something strongly enough and are persistent enough in demanding it, they will get it. That could include taking actions to curb what will be, in the aftermath of the pandemic, deficits and a debt of previously unimaginable proportions. Ideally, both will happen at the same time: Political leadership and the public will converge in a way that allows us to finally confront the debt.

But those who seek to motivate the public to take this problem seriously must be careful to learn a crucial lesson from the past several decades: Warning of impending doom is not the right way to help Americans grasp the need for action. The risks involved in massive debt burdens are medium- and long-term risks, even now. That doesn’t make them less real. Although they may not be immediate, they can be managed in more fair and sustainable ways if we begin to take them up sooner rather than later.

The debt threatens our country’s ability to prosper in the decades to come, but it probably will not bring on a sharp and sudden catastrophe. That means it poses a particularly difficult challenge for our politics.
If the only way to motivate politicians and voters to take the debt seriously is to insist that we are on the edge of an abyss, we will almost certainly fail to address the challenge. Rather than scare ourselves senseless, we need to take responsibility for the future—and to treat Americans like serious adults who can understand what responsibility might mean.

For decades, those warning that rising deficits and debt will lead to a sharp and catastrophic economic calamity were crying wolf. According to Aesop’s fable, the villagers, tired of being tricked by the bored boy, started to ignore him. But that is not where the story ends. Eventually, the wolf did come. And things did not turn out well for the villagers when they ignored the boy then.