

Don't Let Them Fool You, We Still Have Debt Problems

William G. Gale

Abstract

Your uncle, Sam, has ignored his chronic health condition – let's say he's diabetic – for a long time. Then he suddenly has a heart attack, followed by a long, slow painful recovery. As he is recovering, he is feeling good about his health – after all, he got through a crisis. But he is not actually healthier than he was before. He's still diabetic, and now he has to deal with the cautions of being a heart attack victim as well. I think of a situation like that whenever I hear or read people saying that our debt problems are behind us.

Document date: June 01, 2013

Released online: June 01, 2013

Real Clear Markets

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I think of a situation like that whenever I hear or read people saying that our debt problems are behind us. It's true that there has been good news recently on a variety of fronts regarding the budget, but it is premature to say that we've solved the long-term fiscal imbalance.

Fiscal optimism stems from the Congressional Budget Office's most recent estimates, which place the deficit at 4 percent of GDP this year, falling as low as 2 percent of GDP by 2015, before rising to about 3.5 percent of GDP by 2023. These figures are way down from the deficit of 10 percent of GDP that prevailed a few years ago. Some of this reduction is due to the slowly improving economy. The rest is due to policy changes, slower health care cost growth, and various technical factors.

But the fiscal problem isn't gone. There are really two different deficits out there – the short-term and the long-term.

Short-term deficits are a useful tool in a weak economy with very low interest rates. They boost aggregate demand and help close the gap between actual and potential output. If anything, current deficits should be larger than they are, given the \$800 billion gap between what we actually produce and what we could produce. The policies that have brought this year's deficit down – including the sequester, the tax increases on high-income households, and the expiration of the payroll tax cut – are holding the recovery back and are solving the wrong deficit problem.

The long-term deficit is where the real concerns about fiscal sustainability lie. When an economy is running at full steam, increased deficits crowd out private investments, boost interest rates, and reduce future living standards. They mortgage our future. So, while the headlines and commentators trumpet the reduction in the current-year deficit, the real fiscal concern is how we are doing on the long-term front. We are slowly recovering from the heart attack, but not addressing the chronic conditions.

Here, it is instructive to compare the current long-term situation to that which existed before the Great Recession. Economists and political leaders were rightly concerned about the long-term fiscal situation at that time. In many ways, however, the fiscal outlook is worse now than it was then.

Most obviously, the debt/GDP ratio is now almost 75 percent, double the size it was pre-recession and the highest in U.S. history except for 7 years around World War II. Carrying that extra load (much less paying it down) is the equivalent of Uncle Sam walking around with an extra 30 pounds on his waist. It will be a drag on economic activity and limit our policy mobility, or it will force painful changes.

In addition, the long-term economic growth rate is now projected to be lower than it was pre-recession. One of the documented effects of financially-induced recessions is not just that the subsequent recovery is slow but often that the underlying growth rate of the economy is reduced as well.

And of course these changes are playing out with the full retirement of the baby boom, which will reduce

revenues and raise Social Security and Medicare expenditures, much closer than it was pre-recession, giving us less time to make policy adjustments.

On the positive side, there the recent slowdown in the growth rate of health care spending is potentially very good news for the long-term budget. But no one knows at this stage how much of the slowdown will prove to be permanent.

In any case, there are two appropriate reactions to the notion that the debt crisis has been resolved. First, there never was a crisis, in the sense of a potential massive withdrawal of capital from the U.S. or from federal debt instruments, as evidenced by the exceedingly low interest rate on federal obligations. Calling the fiscal imbalance a crisis is and always has been a "cry wolf" strategy designed to get policymakers' attention. The only potential debt crisis we faced was the politically manufactured one that would have occurred had we not raised the debt ceiling.

Second, the long-term problems remain and in some ways are more serious than before. These concerns are inherently less dramatic than the events of the last few years, but that does not make them less important. Most economic models show that the long-term effects of debt buildup can be quite large, much larger than the impact of other policies, such as tax reform. But the effects are not sharp and spiked; they are gradual and persistent, without a particular drop-dead date. As a result, political leaders largely ignored the long-term problem before the recession and are now looking for a reason to ignore it again.

Policymakers need to be more active on both the short- and long-term fronts. Not only is the long-term imbalance not an excuse to avoid short-term actions, addressing short- and long-term problems at the same time would actually be more effective than addressing either problem in isolation. Carefully-crafted stimulus now would help the budget over time by boosting the economy. A long-term budget plan would increase the impact of a stimulus package by showing that the fiscal trajectory was under control. What is remarkable is that policy makers' response to both the heart attack the economy went through the last few years and the chronic conditions it faces is to do nothing on either front.

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