

The Daily Dish

High Debt Levels and Tipping Points

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If the 2011 debate is any guide, be prepared for lots of discussion about "tipping points" associated with high levels of federal debt. For simplicity, think of the level of debt relative to gross domestic product (GDP), which puts the debt relative to the resources in principle available to service it.

One such tipping point is the assertion that there is a particular level of debt – say, for example, 150 percent of GDP – beyond which global capital markets will revolt and the United States would enter a Greece- or Portugal-style sovereign debt crisis. This makes no sense whatsoever.

Markets will cut a country off from further borrowing when participants become convinced that there is not sufficient governance capability to make timely payments of interest and principal. This could happen because the debt has become quite large relative to the economy and raising the money is simply not feasible. But it could also happen because the government itself is too weak to raise even small amounts of revenue, even at low levels of debt. And in both cases, the key moment is when the market anticipates that repayment is in jeopardy; it will not wait until the moment it first happens. So, there is no numerical tipping point, just the reminder that providing effective governance is a key job for the federal government.

The second tipping point is the notion that once debt gets too large, economic growth suffers. There is good reason to be concerned about the chronic deficits that lead to high debt. The whole point of the borrowing is for the government to get its hands on private-sector resources (dollars) and use them in the government programs. This has a cost. (It could do this via taxes, but there are also costs to excessively high taxes.)

Taking a dollar from a private investment and putting it into the most effective federal investment, on average, lowers the return by 50 percent. Unfortunately, that is the best

case because roughly 75 percent of government spending is consumption and not investment. As a result, the chronic high deficits will undercut private investment in skills, capital, and technology, and undercut the growth in productivity and the standard of living. This danger shows up as stagnating growth in GDP and the standard of living.

The empirical analyses suggest that there is a tipping point where mature economies that have more debt pay a penalty of 1 percentage point in slower annual growth. Estimates of this tipping point center on 100 percent of GDP and may be as low as 80 percent or comparably higher. These estimates caution against the notion that further increases in the debt are costless and, more important, that stabilizing and reducing the debt has the benefit of better growth.

If history is a guide, the debate will be vigorous but not uniformly clear. Be prepared to scrutinize any claim of an approaching tipping point carefully.