Insight

How Much Deficit Reduction?

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Debt reduction is a clear imperative. But how much? The right answer appears to be in the vicinity of **$4 to 5 trillion**.

Federal debt has reached $16.4 trillion, or 104 percent of Gross Domestic Product (GDP). *The historical record suggests that when sovereign debt exceeds 90 percent of GDP, growth is slower by 1 percentage point (compared to a comparable economy with low debt) and the risk of financial crisis is elevated.[ii] That suggests that a sensible target is **85 percent**, which would reduce the federal debt below the historic "danger zone." This would require $4.7 trillion in deficit reduction.*
In contrast, a recent analyses has been put forth to argue that modest deficit reduction of $1.4 trillion should be the target. The argument is that in the aftermath of the passage of recent tax increases and spending cuts in the American Taxpayer Relief Act (ATRA) and the Budget Control Act (BCA), respectively, this target will be sufficient to stabilize the debt as a share of GDP in the next 10 years.[iii]

The $1.4 trillion target is flawed in several respects.

First, the circumstances in which $1.4 trillion in deficit reduction would actually stabilize the debt (relative to GDP) in ten years hinge on a series of assumptions. In addition, it assumes that tax policy is essentially frozen in the aftermath of the fiscal cliff deal. That is not so obvious. As the authors acknowledge, passage of a series of tax "extenders" (as has historically been the case) would change the size of needed deficit reduction in their scenario by $400 billion, or about 29 percent.

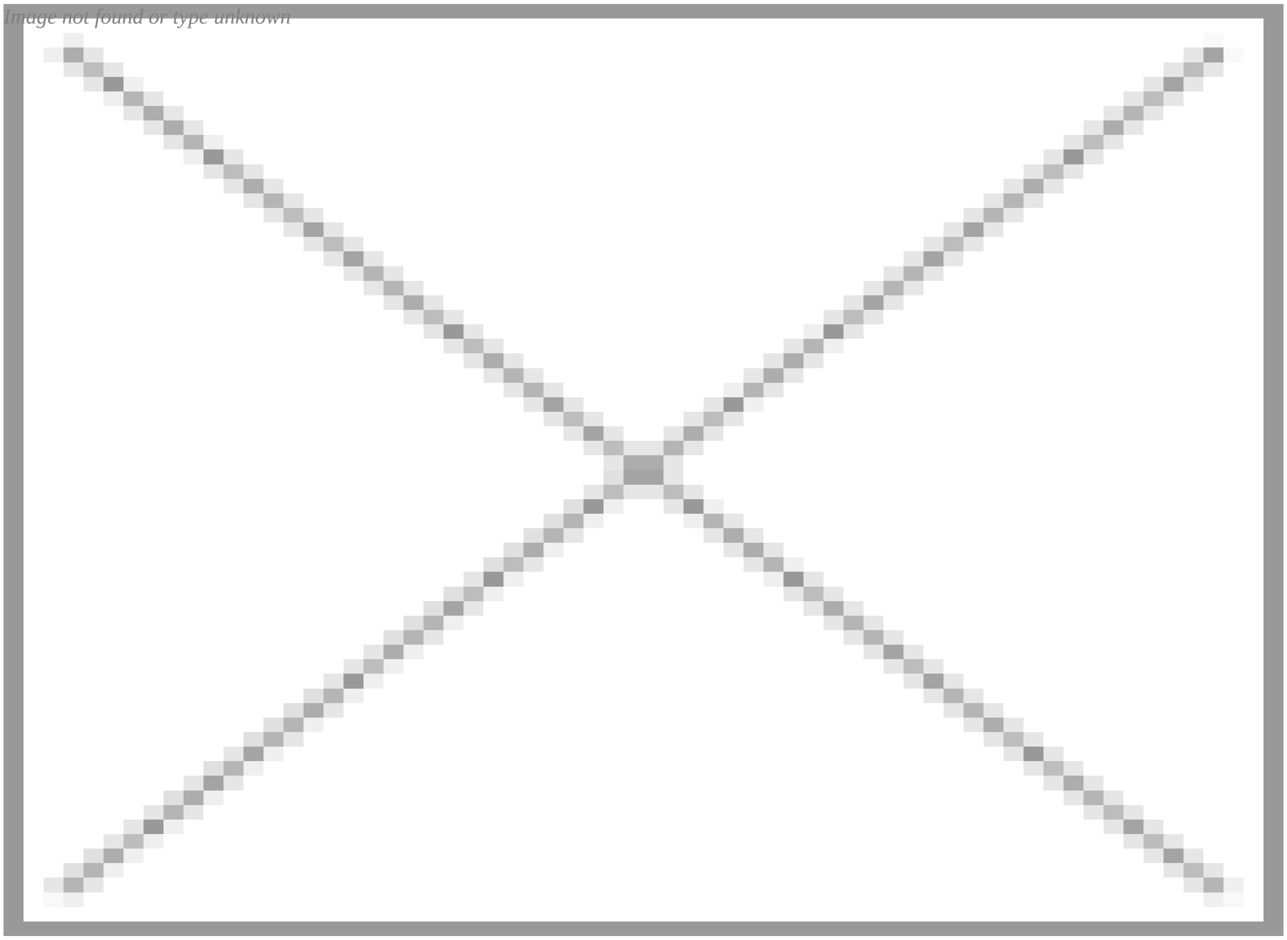
A second, more serious, concern is that the metric for success – debt stabilization within the ten year window – is too short-sighted. In successive decades any reasonable debt projection is a guarantee of a future debt crisis. Their medium term analysis and proposed target endows observers with a false sense of security that debt reduction of the magnitude required to address future challenges can be delayed for 10 years.

Lastly, and most importantly, the analysis ignores the fundamental threat posed by the economic implications of high levels of indebtedness. Indeed, the authors note, "While no one knows what 'too high' means for the United States, a debt ratio that rises in both good times and bad will become increasingly problematic." Unfortunately, as noted at the outset we do know what "too high" means.

The economists Carmen Reinhart, of the University of Maryland, and Kenneth Rogoff, of Harvard University, have demonstrated, through rigorous historical analysis of 44 countries over the past two centuries, that when debt as a percent of GDP exceeds 90 percent, median growth is roughly 1 percent lower than countries with lower debt burdens — meaning that instead of a 3 percent increase in GDP over the course of a year, a country with a greater than 90 percent debt-to-GDP ratio would have a 2 percent increase. U.S. national debt currently exceeds 100 percent of GDP.

As shown in the figure below, both current policy and the $1.4 trillion deficit reduction target would leave the U.S. in the danger zone of chronically impaired growth and elevated risk of financial crisis. The target of
85 percent

, however avoids these risks.



*An indefinite growth penalty of 1 percent would impose an annual penalty on the order of one million jobs.[iv] Persistently slow growth would also impair the growth in standards of living. Median household income was $50,054 in 2011.[v] The Congressional Budget Office assumes in its long-term budget outlook that nominal income growth should average **4.4** percent until 2023, **3.9** percent from 2023-2033, and **4.1** percent from 2033-2043. Without aggressive deficit reduction sufficient to exit the danger zone and avert the Reinhart-Rogoff growth penalty, the growth penalty would translate to a cost in median income of **$8,068**in 2023 and would grow to **$2***

GDP was $15.8 trillion in the 3rd quarter of 2012.