Joint Economic Committee

Senator Sam Brownback, Ranking Republican

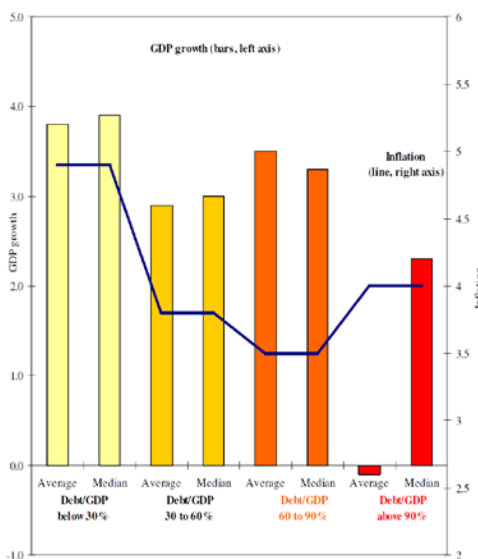
New Findings Reveal Significant Negative Impact of Government Debt Buildup on Economic Growth

January 11, 2010

"The sharp run-up in public sector debt will likely prove one of the most enduring legacies of the 2007-2009 financial crisis in the United States and elsewhere," concludes a recent paper presented at the American Economic Association. This important study reveals some compelling data and findings on the relationship between significant buildups in government debt and declines in economic growth. In their paper, titled "Growth in a Time of Debt," economists Carmen Reinhart (University of Maryland) and Kenneth Rogoff (Harvard University) utilize a comprehensive new dataset to analyze the impact of government debt on GDP growth and inflation.[1] The study is particularly timely in light of the recent financial crisis and ensuing buildup of government debt across the globe.

Examining new data across 200 years and 44 countries, Reinhart and Rogoff find that both emerging and advanced economies experienced remarkably similar relationships between high debt levels and reduced growth. Emerging economies were more susceptible to negative growth effects from high levels of total external debt (public plus private) and from run-ups in inflation. Although the study found no systematic relationship between high levels of debt and inflation among advanced economies, the authors did note some exceptions (including that of the United States, which has experienced a positive link between debt and inflation).

Although the authors do not distinguish between the causes of debt buildups, they do note that peace-time debt buildups are more problematic than those in war-time. Peace-time debts have no natural end and can indicate unstable underlying political economy dynamics which may endure for a long time. Because of the more harmful nature of peace-time debt accumulation, the negative impact of the recent debt buildup in the U.S. and across the globe may be more severe than what these longer-term results, incorporating both peace- and war-time debt buildups, would imply.

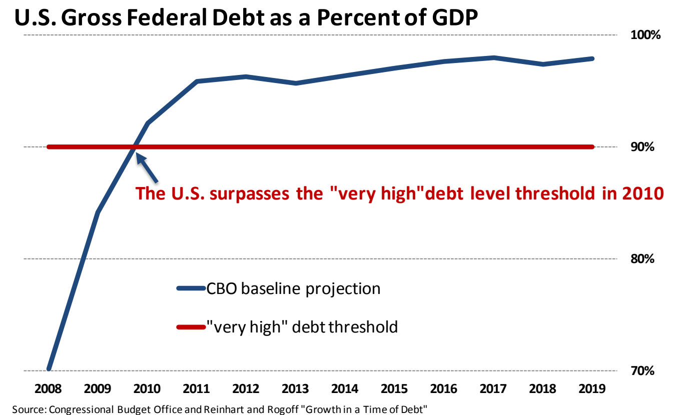


When comparing 20 advanced economies in the post- World War II time period (1946-2009), Reinhart and Rogoff found a distinct debt threshold—equal to 90 percent or more of gross domestic product (GDP)—at which point debt level had a significantly negative impact on GDP growth (see figure to the left from the study).[2] For countries with debt levels greater than or equal to 90 percent of GDP (classified as very high debt), median GDP growth

[1] Reinhart, Carmen M. and Kenneth S. Rogoff, "Growth in a Time of Debt," December 31, 2009 draft, prepared for the *American Economic Review Papers and Proceedings*.

[2] The authors classified debt levels, by country and year, according to the following four classifications: low (below 30 percent of GDP); medium (30 to 60 percent); high (60 to 90 percent); and very high (above 90 percent).

was 1 percentage point below that of countries with lower debt levels. Average growth levels revealed an even greater impact: average GDP growth in countries with very high debt was a full 4 percentage points below that of countries with lower debt.



After growing substantially as a percent of GDP over the past decade, gross federal debt in the U.S. exploded during the recent financial crisis and is predicted to continue growing for the foreseeable future due to rising spending levels and growing entitlement burdens. Between 2008 and 2009, gross federal debt in the U.S. rose from 70% of GDP to 84%, and is projected to reach 92% in 2010. The Congressional Budget Office predicts the U.S. debt level will approach 100% of GDP by the end of the decade, and will continue to rise beyond that point due to growing entitlement burdens.[3] The findings of this study reveal that the recent buildup in debt in the U.S., combined with proposed government spending increases over the following decade and impending budgetary pressure from entitlements, could cause a significant and prolonged decline in American economic growth.

For those who expect or hope that the U.S. can "grow" itself out of its fiscal difficulties, Reinhart and Rogoff caution that, "seldom do countries simply 'grow' their way out of deep debt burdens." Rather, countries that have accumulated large federal debts must take comprehensive action to reduce their debt levels. Before debt can be reduced, however, it must stop accumulating. To allow our economy to meet its long-run growth potential, current and future spending must be brought into balance with revenues. If this is not done, the U.S. and other countries that face similar fiscal situations risk rising interest rates on debt burdens and the inability to finance current spending. As Reinhart and Rogoff note, "Even countries that are committed to fully repaying their debts are forced to dramatically tighten fiscal policy in order to appear credible to investors and thereby reduce risk premia."

In addition to examining public debt levels, Reinhart and Rogoff observed the effect of financial crisis on private debt. In contrast to public debt, private debt tends to contract sharply for some time following a financial crisis. The deleveraging of private debt tends to exacerbate the post-crisis downturn by causing lower growth and higher unemployment. In the U.S., in particular, the authors note that private deleveraging is typically accompanied by very slow growth and deflation. In relation to previous financial crisis, the authors observe that "the magnitude of the current deleveraging episode in the United States has no counterpart in the post-war period."

This study serves as a warning to the United States and other countries that have accumulated significant debt levels in response to the financial crisis. While "outsized deficits and epic bank bailouts" may be useful in combating a recession, higher government debt levels—particularly at a time of aging populations and rising social insurance costs—pose a serious threat to long run economic growth and well-being.

---

[3] These are CBO's "baseline" budget projections, which assume that, among other things, all expiring tax provisions, including EGTRRA and JGTRRA, are not extended, and that the AMT is not patched or indexed for inflation.