The Problems Posed by Rising Federal Debt

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Committee on Financial Services

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Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for convening this hearing and providing me with the opportunity to address one of the preeminent risks to the U.S. economy: the national debt. Both the level and the projected growth of the federal debt pose significant risks. Either would be (and have been) troubling to observers, but together they raise this issue to a first-order economic concern. Addressing this challenge will require a combination of policies that will constitute difficult choices for the American public. Unfortunately, the task becomes harder the longer policymakers avoid it. Merely stabilizing the debt relative to the size of the U.S. economy, arguably a modest fiscal goal, will require a significant fiscal consolidation. This challenge intensifies the longer action is deferred, and will likely require more revenue growth, significantly slower mandatory spending growth, and sustained rapid economic growth.

The Budgetary Outlook

The federal government faces enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises. The core, long-term issue has been outlined in successive versions of the Congressional Budget Office's (CBO's) *Long-Term Budget Outlook*.[1] In broad terms, the inexorable dynamics of current law will raise federal outlays from an historic norm of about 20 percent of gross domestic product (GDP) to nearly 30 percent of GDP. Spending at this level will far outstrip revenue, even with receipts projected to exceed historic norms, and generate an unmanageable federal debt spiral.

This depiction of the federal budgetary future and its diagnosis and prescription have remained unchanged for at least a decade. Nevertheless, meaningful action (in the right direction) has yet to be seen, as the most recent budgetary projections demonstrate.

In April, the CBO released its updated budget and economic baseline for 2018-2028. The basic picture is as follows: Tax revenues eventually return to pre-recession norms, while spending progressively grows over and above currently elevated numbers. The net effect is an upward debt trajectory on top of an already large debt portfolio. The CBO succinctly articulates the risk this poses: "Such high and rising debt would have serious negative consequences for the budget and the nation… Lawmakers would have less flexibility to use tax and spending policies to respond to unexpected challenges. The likelihood of a fiscal crisis in the United States would increase. There would be a greater risk that investors would become unwilling to finance the government's borrowing unless they were compensated with very high interest rates. If that happened, interest rates on federal debt would rise suddenly and sharply."[2]

Figure 1: The Budget Outlook by the Numbers

[1] Congressional Budget Office. 2018. *The Long-Term Budget Outlook.* Pub. No. 53919. https://www.cbo.gov/publication/53919
[2] Congressional Budget Office. 2018. *The Budget and Economic Outlook: 2018 to 2028.* Pub. No. 53651. https://www.cbo.gov/publication/53651

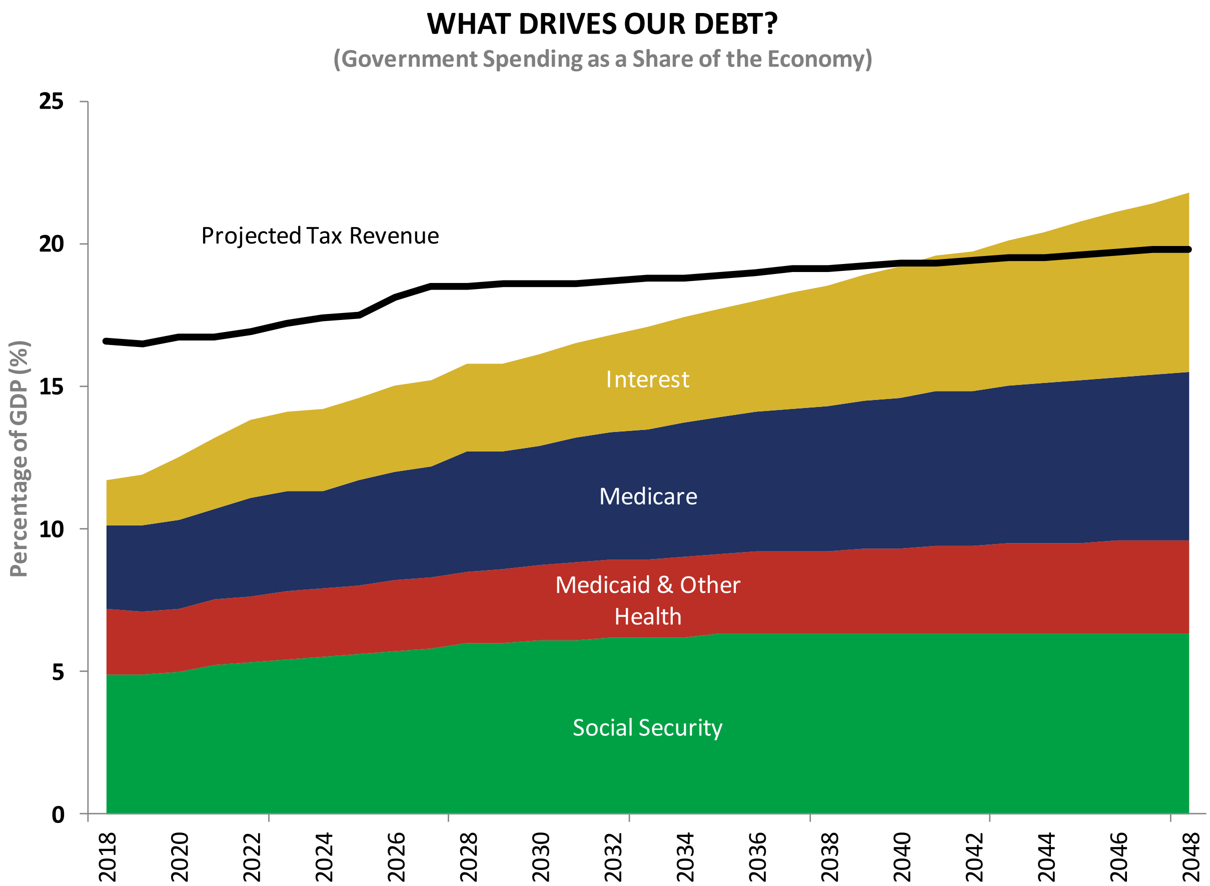
		2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2019-2028
Revenue	$ Billions	3,338	3,490	3,678	3,827	4,012	4,228	4,444	4,663	5,002	5,299	5,520	44,162
	% of GDP	16.6	16.5	16.7	16.7	16.9	17.2	17.4	17.5	18.1	18.5	18.5	17.5
Outlays	$ Billions	4,142	4,470	4,685	4,949	5,288	5,500	5,688	6,015	6,322	6,615	7,046	56,580
	% of GDP	20.6	21.2	21.3	21.6	22.3	22.3	22.2	22.6	22.9	23.1	23.6	22.4
Deficit	$ Billions	804	981	1,008	1,123	1,276	1,273	1,244	1,352	1,320	1,316	1,526	12,418
	% of GDP	4	4.6	4.6	4.9	5.4	5.2	4.9	5.1	4.8	4.6	5.1	4.9
Debt	$ Billions	15,688	16,762	17,827	18,998	20,319	21,638	22,932	24,338	25,715	27,087	28,671	
	% of GDP	78	79.3	80.9	83.1	85.7	87.9	89.6	91.5	93.1	94.5	96.2	

According to the CBO, tax revenue will average 17.5 percent of GDP over the next 10 years. This rate is roughly on par with the 17.4 percent of GDP that has been the average level of taxation over the past 50 years. The federal government is projected to spend over $56 trillion over 10 years, maintaining spending levels 2.1 percentage points above historical levels. Mandatory spending, which comprised 28 percent of the federal budget in 1968, will reach 64 percent in 2028. Interest payments on the debt comprised 6 percent of the budget in 1968 and 6 percent in 2016. These payments will rise to 13 percent of the budget. Debt service payments will reach 3.1 percent of GDP by 2028 – well in excess of the 50-year average of 2.0 percent.

Sources of Rising Debt

As reflected in the CBO's budget projections, the problem facing the United States is that spending rises above any reasonable target for tax revenue for the indefinite future. There is a mini-industry devoted to producing alternative numerical estimates of this mismatch, but the diagnosis of the basic problem is not complicated. The diagnosis leads as well to the prescription for action. Over the long-term, the budget problem is primarily a spending problem, and correcting it requires reductions in the growth of large mandatory spending programs – primarily entitlements, meaning Social Security and federal health programs.

Figure 2: Mandatory Spending is Driving our Deficits



Medicare is projected to grow at 8 percent on average over the next decade and is currently running a cash deficit of over $330 billion.[3] Social Security is projected to grow at an average rate of 6 percent, while currently running a cash-flow deficit of $41 billion. Medicaid and the insurance subsidies associated with the Patient Protection and Affordable Care Act (ACA) are growing at 6 and 5 percent on average every year. In contrast, the economy that is the ultimate source of financing of these obligations is projected to grow at only 4 percent annually. The costs of the nation's entitlements increasingly dominate federal expenditures and, as reflected in Figure 2, will eventually swamp projected tax revenue.

Consequences of National Debt

Both the level and the trajectory of the nation's debt are of serious concern.

Concerns About the Level of Debt

The level of debt, irrespective of its growth rate, exposes the federal government to interest rate risk. With $15.968 trillion in debt held by the public, the federal budget is highly

[3] https://www.americanactionforum.org/research/the-future-of-americas-entitlements-what-you-need-to-know-about-the-medicare-and-social-security-trustees-reports/

sensitive to interest rate fluctuations. With such a large level of debt outstanding, even small interest rate changes generate large budgetary consequence. According to the CBO, even a 0.1 percentage point rise in prevailing interest rates would increase federal debt service costs by $165 billion.[4]

As also noted above by CBO, the current high level of debt risks policymakers' ability to respond to economic or geopolitical events. The attacks on September 11, 2001 and the contemporaneous recession necessarily increased claims on federal resources and greater borrowing needs. So too did the federal response to the Great Recession by Presidents Bush and Obama. High levels of debt risk limiting policymakers' ability to respond rapidly to similar future crises.

Finally, the empirical evidence indicates that, in general, high debt is correlated with slower economic growth. There has been a vigorous debate in the economics literature on this finding, its magnitude, and whether it represents a causal relationship.[5] There is a clear understanding, however, that debt absorbs private savings, and eventually saps the economy of needed capital investment. Worse, in the midst of slow growth, any rapid imposition of needed fiscal consolidation would further harm short-run economic growth. For example, CBO estimated that the "fiscal cliff" at the end of 2012 would have imposed a 3.9 percent growth penalty on the U.S. economy.[6] Such rapid policy change would ultimately reinforce negative budgetary pressures.

Concerns About the Rate of Debt Growth

The debt is projected to grow more rapidly than the economy indefinitely. At some point creditors will effectively refuse to continue financing our deficits by charging ever-higher interest payments on an increasingly large debt portfolio. Unchecked accumulation of debt would precipitate a fiscal crisis that would upend world financial markets and do lasting harm to the nation's standard of living.

In such a hypothetical fiscal crisis, the policy response most readily available to lawmakers would be ill-targeted insofar as it would likely leave untouched the large drivers of the debt itself – health and retirement entitlement programs. Such programs do not lend themselves to immediate reduction. Accordingly, a fiscal consolidation that was forced by creditors would likely take the form of tax hikes and cuts to discretionary spending. These tax hikes and discretionary spending increases would be sharp and immediately felt.[7]

The nation would also face immediate and steep interest penalties on financing its shorter-term debt portfolio. About half of all U.S. debt held by the public is of 3 years or less in

[4] https://www.cbo.gov/system/files?file=2018-06/54052-cbos-rules-thumb.pdf
[5] See https://www.bostonfed.org/-/media/Documents/economic/conf/Monetary-Fiscal-Topics-2011/papers/hubbard.pdf and a related discussion https://www.ijcb.org/journal/ijcb12q0a12.pdf
[6] http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf
[7] The forgoing discussion is based on previous testimony first presented to the House Financial Services Committee: https://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-dholtzeakin-20140325.pdf

duration. All else being equal, the higher costs of rolling over this portfolio would also have to be borrowed or absorbed through significant, additional tax increases and spending.

An immediate fiscal contraction from a debt crisis would have a deleterious effect on the economy. From a purely budgetary perspective, large and immediate tax increases and spending cuts would reduce growth and immediately reduce the revenue collected from tax increases. Spending would also increase as certain automatic stabilizers come into force as the economy flags.

A debt crisis has three key features: abrupt and large fiscal consolidations, high interest rates, and weak economic growth. All three have real implications for individuals and families.

The policy response would certainly be visible to individuals. It is difficult to quantify how the reduced budgetary resources would be experienced individually, but there would be clear erosions in defense readiness, education expenditures, and research initiatives. Other, more basic services, many of which were recently disrupted during the smaller sequester, would be reduced.

With respect to tax policy, a clearer picture can be drawn. According to recent projections, in 2027 the average federal tax rate, which includes payroll and corporate taxes, will be 20.2 percent.[8] A tax increase adequate to achieve an immediate fiscal consolidation would take that rate up several percentage points. It would be very unlikely, however, that a policy response would fall evenly across all taxes and all tax brackets. Rates would have to be commensurately higher as fewer taxpayers and less of the tax base are exposed to higher rates of taxation.

The second distinguishing element of a debt crisis is a high interest-rate environment. The U.S. Treasury security is the benchmark for the cost of funds and underpins all manner of consumer financial products. Prime mortgage rates are highly correlated to Treasury notes.[9] Accordingly, one can construct a notional mortgage rate in an extraordinarily high interest rate environment. If the 10-year Treasury jumped 1000 basis points, today's prevailing mortgage rate of 4.81 percent would jump to 14.81 percent.[10] For the sake of comparison, at today's rates, monthly interest and principal payments on a $250,000 home loan would amount to $1,313. At 14.81 percent, payments would jump to $3,123.[11] The example holds true in other matters of consumer finance, such as car loans and student loans. The resulting increase in costs would have additional and deleterious effects on the economy.

How Big Do the Changes Need to Be?

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[8] http://www.taxpolicycenter.org/model-estimates/baseline-distribution-income-and-federal-taxes-march-2017/t17-0015-baseline
[9] See: http://www.freddiemac.com/pmms/pmms_archives.html; http://www.federalreserve.gov/releases/h15/data.htm
[10] http://www.freddiemac.com/pmms/
[11] https://www.dallasfed.org/educate/calculators/closed-calc.aspx

The CBO recently released an excellent study identifying the magnitude of fiscal consolidation needed to achieve various fiscal targets.[12] The last time the nation's debt burden approached current levels was during and immediately after World War II. Unlike the 1940s, the United States cannot simply demobilize a war-time economy. Instead, the federal government will need to make fundamental changes to major health, retirement, and other spending programs as well as the tax code. To reduce the debt by 2048 to its 50-year historical average of 41 percent of GDP, the CBO recently calculated, policymakers would need to enact a fiscal consolidation of 3 percent of GDP *each and every* year compared to current budget projections. Merely stabilizing the debt at its current level of 78 percent of GDP (the current level) in 2048 would require sustained, primary deficit reduction of 1.9 percent of GDP every year. Either approach would reflect unprecedented but essential fiscal consolidation.

The American Action Forum (AAF) has also completed several separate long-term budget proposals that would place the United States on a sustainable fiscal footing.[13] Each reflects the imperative to curb the growth in federal outlays dramatically, particularly with respect to mandatory spending, and to reform the tax code to collect adequate revenue efficiently. AAF will be joining a number of other research institutions in another iteration of this project made possible by the Peterson Foundation. I should also note that one of my fellow witnesses, Brian Riedl, who will also be participating in that project, released a remarkable report in October detailing the scope and scale of this challenge.

Policy Recommendations

The U.S. budgetary challenge will resolve itself – either at the hands of creditors or through deliberate policy choice, or some combination of both. Clearly, the deliberate approach would be preferred to fiscal consolidation. If there is a single principle that should guide the construction of a fiscal consolidation, it is that policy choices should be biased in favor of economic growth. This approach means revenue collection should be efficient, and spending constraint should focus on slowing the growth in transfer payments to ensure key federal responsibilities in national security, basic research, education, and infrastructure are prioritized.

Purely budget-driven arguments are likely insufficient to marshal support for entitlement reform. The large entitlement programs need reform in their own right, however. Social Security is a good example: Under current law, retirees will face a 23-percent across-the-board cut in benefits in less than two decades.[14] That is a disgraceful way to run a pension system. It is possible to reform Social Security to be less costly overall and financially sustainable over the long term.

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[12] https://www.cbo.gov/system/files?file=2018-08/54181-DebtTargets.pdf

[13] See: https://www.americanactionforum.org/insight/balanced/; https://www.americanactionforum.org/research/aafs-balanced-2028/

[14] https://www.americanactionforum.org/research/future-americas-entitlements-need-know-medicare-social-security-trustees-reports/

Similar insights apply to Medicare and Medicaid, the key health safety nets for the elderly and poor. These programs have relentless appetites for taxpayer dollars yet do not consistently deliver quality outcomes. Reforms can address their open-ended draws on the federal Treasury and improve their functioning at the same time.

Growth-oriented fiscal strategy will re-orient spending priorities away from dysfunctional autopilot spending programs and toward core functions of government. It will focus less on the dollars going into programs and more on the quality of the outcomes. Such a strategy will do so because it is the principled approach, because it coincides with the best strategy to deal with the debt and growth dilemmas, and because it will force a restructuring of the entitlement programs to generate a quality social safety net.

Conclusions

The United States has had a growing debt challenge for decades. What was a long-term problem has now become a pressing and immediate concern. The magnitude and pace of the nation's debt accumulation will require an unprecedented fiscal consolidation. While that process will be challenging, it should forestall the greater risks posed by either the toxic combination of high debt and anti-growth but inadequate policy choices or a fiscal crisis of a scale unseen in modern history. Despite the high stakes, the policy course is somewhat straightforward: Complete the unfinished business of tax reform and slow the growth of America's large entitlement programs.