



## INTEREST PAYMENTS ON THE FEDERAL DEBT

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Unprecedented levels of government spending, mostly in response to the financial crisis, have resulted in the highest level of public indebtedness in the United States since World War II. As the national debt rises, the interest on the federal debt merits increased scrutiny and concern, especially given the government's levels of short-term debt and potential inaccuracies in measuring the true interest costs on the debt.

### RESEARCH FINDINGS

- Interest on debt represents a very real cost of federal borrowing. Government borrowing to fund persistent deficits is not free—the Department of the Treasury must pay interest to holders of U.S. debt. Ultimately, the cost of this debt is a function of two different factors: the level of government indebtedness and the interest rates on government debt instruments.
- In addition to the nominal value of national debt, the ratio of debt to GDP has increased sharply. Total federal debt includes debt held by the Federal Reserve Board and by the Social Security Trust Fund. Broadly speaking, the debt-to-GDP ratio provides some insight as to how sustainable a country's borrowing is based on its total output. Over the coming fiscal year, the debt held by the public is expected to grow from an initially estimated 53.1 percent of GDP to more than 60 percent of GDP.<sup>1</sup> While public debt as a percentage of GDP was higher during World War II, some government forecasts predict that continued deficits will drive debt to a higher level than it was during World War II.<sup>2</sup>
- Given the large amounts of recent federal spending, spending on interest is likely to increase. In its fiscal year 2010 budget, the executive branch estimates that net interest payments will jump to more than 11 percent of the federal budget by 2014. A Congressional Budget Office (CBO) estimate finds that net interest costs will double from just below 1.5 percent of GDP in 2010 to nearly 3 percent of GDP in 2015. If such estimates are realized, net interest on the debt would be higher than any level since World War II.<sup>3</sup>
- Financing stimulus spending through short-term borrowing has placed the federal government in an increasingly vulnerable position. A large portion of the current debt (\$4,509 billion, or 65 percent of total federal debt) must be paid in the coming four years, and payment will require either a tax increase, or a drop in government spending, or a refinancing of debt. Furthermore, short-term debt is subject to significant interest-rate volatility, which may be a danger given the aforementioned CBO estimates. Furthermore, Treasury Notes and Treasury Inflation-Protected Securities (TIPS) maturing within the next 10 years total \$4,169 billion.<sup>4</sup>
- To determine future liabilities, policy makers must predict future interest rates and debt levels—both which are difficult to forecast. In its July 2009 staff report on the United States, the International Monetary Fund (IMF) estimates significantly higher levels of federal government debt than estimates by the Office of Management and Budget (OMB).<sup>5</sup> While OMB predicts that publicly held federal debt will level off at just less than 75 percent of GDP between 2010 and 2019, the IMF estimates ??? that during that period, publicly held debt will increase to 100 percent of GDP.
- The consequences of misestimating can be severe. Earlier this decade, the CBO found that if interest rates increased by one percentage point over its baseline estimates, interest costs to the federal government would

<sup>1</sup> GAO, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2009 and 2008 Schedules of Federal Debt*, GAO-10-88 (Washington, DC: GAO, November, 2009), 3, <http://www.gao.gov/new.items/d1088.pdf>.

<sup>2</sup> Douglas W. Elmendorf, *The Economic and Budget Outlook* (Washington, DC: CBO, American Association for Budget and Program Analysis, November 24, 2009), 24, <http://www.cbo.gov/ftpdocs/107xx/doc10748/11-24-09AABPA-Presentation.pdf>.

<sup>3</sup> Congressional Budget Office, *The Budget and Economic Outlook: An Update* (Washington, DC: CBO, August 2009), 14, <http://www.cbo.gov/ftpdocs/105xx/doc10521/08-25-BudgetUpdate.pdf>.

<sup>4</sup> GAO, *Financial Audit*, 13.

<sup>5</sup> International Monetary Fund, *Staff Report for the 2009 Article IV Consultation*, July 9, 2009, 34.

increase by about \$11 billion in fiscal year 2004.<sup>6</sup> A payment shock may prompt policy makers to:

- Make increased payments on the debt. Efforts such as increasing tax revenue or assuming more debt to pay unexpected interest costs can hamper economic growth by crowding out private spending and investment.
  - Inflate away the debt—a higher price level in the future means that money being paid to lenders (principal and interest) is worth less than the money that the government lent. But inflationary policies can have other adverse economic effects, decrease the government’s credibility, and hamper its ability to finance future debt.
- **Interest payments on the national debt are unsustainable.** In its updated budget and economic outlook, the CBO found that continued deficits and growing debt levels will threaten future economic growth and merit “some combination of lower spending and higher revenues than the amounts now projected.”<sup>7</sup> A recent GAO report found that the long-term fiscal outlook is “unsustainable.”<sup>8</sup>

## CONCLUSION

Massive increases in the federal debt have garnered public attention, however rising interest on the national debt is another concern among policy makers. In addition to challenges in lowering the total debt, the government may face additional challenges given its abundance of short-term debt with fast-approaching maturity dates. Furthermore, difficulties in predicting the level of future interest payments on the debt may mean that unexpected expenditures may place additional pressures on economic growth and future private investment. In any case, addressing concerns over large government spending and exercising fiscal discipline may be the best way to ensure sustainable interest payments in future years.

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*The ideas presented in this document do not represent official positions of the Mercatus Center at George Mason University.*

<sup>6</sup> GAO, *Federal Debt: Answers to Frequently Asked Questions, An Update*, GAO-04-485SP (Washington, DC: GAO, August 2004), 27, <http://www.gao.gov/new.items/d04485sp.pdf>.

<sup>7</sup> CBO, *The Budget and Economic Outlook*, 14.

<sup>8</sup> GAO, *Debt Management: Treasury Inflation Protected Securities Should Play a Heightened Role in Addressing Debt Management Challenges*, GAO-09-932 (Washington, DC: GAO, September 2009), 4, <http://www.gao.gov/new.items/d09932.pdf>.