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The United States' Debt Crisis: Far from Solved

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The recent decline in federal deficits should not create a false sense that the national debt is no longer a clear and present threat. While this improvement may be encouraging, it represents only a temporary respite from the government's growing fiscal imbalances. Congressional Budget Office (CBO) estimates show deficits growing again two years from now, returning to trillion-dollar levels within a decade, and worsening from there.

In short, the United States' fiscal outlook has not changed. Americans will soon have to deal with the consequences of being a highly indebted nation. While economists can't predict exactly when or how a debt crisis will manifest itself in the United States, such a crisis is inevitable if current spending trends continue. The longer policymakers delay the needed course correction, the more likely they will be forced to rush through ill-conceived policies in the face of a crisis.

DEFICITS AREN'T GOING AWAY

The improvement in the fiscal situation over the past few years was driven largely by the extraordinarily high deficit levels between 2009 and 2013. The government's deficits surged from about $459 billion in fiscal year (FY) 2008 to $1.4 trillion (9.8 percent of gross domestic product, or GDP) the following year, then remained above the trillion-dollar mark until 2013. They are now projected to fall to $492 billion in FY 2014 (2.8 percent of GDP) and then to decrease further to $469 billion in FY 2015 (2.6 percent of GDP).[1]

In the face of these large deficits, debt held by the public as a share of GDP has continued to grow and is projected to remain near three-fourths of total economic output in the near-term—levels higher than at any time since 1948—and to exceed the size of the entire economy by 2039.[2] Under different assumptions—with looser spending restraints and economic feedback of high government debt factored in—the CBO estimates that the debt-to-GDP ratio could reach 183 percent of GDP by 2039.[3]

Deficits and debt are merely symptoms; the disease is overspending, and only by curing it can Washington correct the phenomenal fiscal imbalance the government faces now and in the future. No level of taxes can close this gap over the long term,[4] and higher taxes would exacerbate the deficit and debt problem by acting as a drag on growth.[5]

The deficits caused by overspending are already impeding growth. For the past several years, following substantial fiscal and monetary stimulus measures, forecasters have predicted a return to normal rates of GDP growth, but these conditions have not materialized.[6] Further, recent job gains mask nagging underlying problems in the employment market, including a historically low labor force participation rate[7] and a chronically high number of long-term unemployed.[8]

THE DEBT PROBLEM PERSISTS

After years of excessive spending, the crude restraints Congress imposed on itself in the August 2011 debt ceiling agreement (spending caps enforced by sequestration) actually yielded a rare absolute decline in federal outlays from 2011 through 2013.[9] Nevertheless, spending is projected to begin surging again this year, approaching $6 trillion within 10 years, or roughly 22 percent of GDP. Of course, this acceleration in spending will also accelerate the growth of deficits and debt.[10]

In just a decade, interest on the debt plus autopilot entitlement programs such as Medicare, Medicaid, Social Security, the Affordable Care Act (ACA), food stamps, and other income support will account for 77 cents of every dollar spent by the federal government, up from 61 cents in 2010. Thus, by 2024, Congress will have only about 23 cents of every dollar for "discretionary" spending, which finances programs such as education, infrastructure and our national defense.[11]

Over the next 25 years, CBO estimates that net "programmatic" spending—that is, spending excluding interest payments—will persistently exceed tax revenue. The borrowing needed to fund this gap will push spending and debt even higher. By 2039, debt held by the public—the money the federal government owes to domestic and foreign investors—will reach 106 percent of GDP.[12]

Worse, the concept of "debt held by the public" actually paints an incomplete picture, as these numbers don't account for two of the federal government's largest future obligations: (1) debt it owes to itself, or (2) promised future benefits that exceed the government's capacity to finance them.

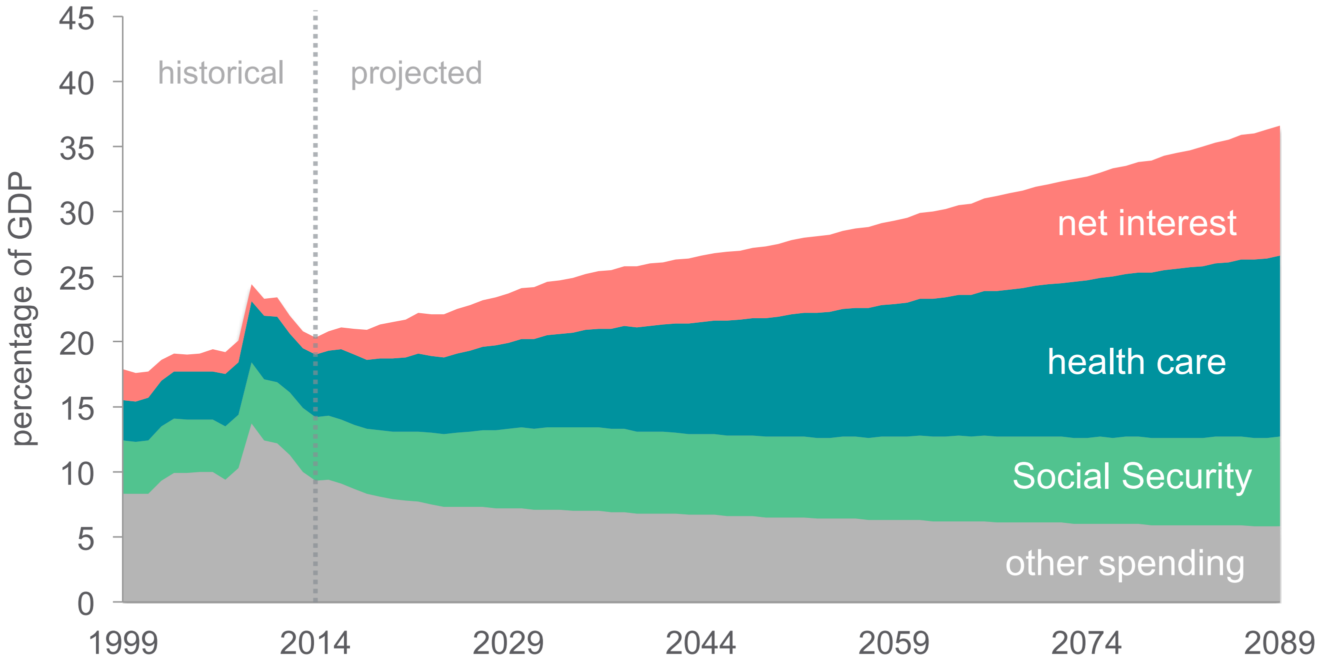
When you add in the debt that government owes to other accounts (e.g., the money it has borrowed from and must pay back to programs such as Social Security), you get gross federal debt, which today already totals $17.7 trillion, or slightly more than 100 percent of GDP. And the debt is projected to keep growing from there.[13]

In addition, the Financial Statement of the United States, which looks at the government's net financial position, reports that as of 2012, Americans have been promised about $55 trillion worth of future benefits (through Medicare, Social Security, and other government programs) that the federal government has not adequately funded.[14] These unfunded obligations should be taken into account when considering the true size of the government's future debt burden.

DEBT IS EXPENSIVE AND SELF-PERPETUATING

By any measure, the current interest rates are historically low, but that is not likely to last. In fact, CBO assumes interest rates on the 10 Year Treasury note will increase within the next 10 years from 2.4 percent in 2013 to 5.0 percent in 2024,[15] and high debt levels will leave the government exposed to these rising rates. Interest payments will nearly quadruple in just a decade (from $227 billion in 2014 to an esti-

FIGURE 1. The largest entitlements and interest on debt consume an ever-greater share of GDP.



Data note: Health care portion represents federal spending on the major health care programs, which consists of spending on Medicare (net of offsetting receipts), Medicaid, CHIP, and subsidies offered through the Affordable Care Act's health insurance exchanges.
Source: Congressional Budget Office, *Long-term Budget Outlook*, July 2014.

mated $876 billion by 2024).[16] By 2039, interest payments will rise from 1.3 percent of GDP this year to an estimated 4.7 percent of GDP in 2039.[17]

The chart above shows the projected interest on the federal debt as a percentage of GDP between 1999 and 2089. This chart also shows CBO's projections for the cost of Medicare and Social Security as a percentage of GDP. As is clear, the cost of debt (net interest payments) rivals the cost of two of the nation's most expensive retirement programs.

As debt grows, so do interest payments, until the government has to borrow just to cover its debt service. That in turn will also swell both the deficit and interest costs because of compounding interest. This effect could be magnified through a combination of concerns about inflation and possible default, and the potential of increasing government debt driving up market interest rates. In other words, deficits financed at low rates today can lead to more deficits, resulting in financing at higher rates in the future. Thus, the spiral of deficits and debt becomes self-perpetuating.

HIGH DEBT SLOWS ECONOMIC GROWTH

There is ample academic evidence that higher debt levels slow economic growth. While there have been challenges to Harvard University economists Carmen Reinhart and Kenneth Rogoff's landmark 2010 paper[18]—which demonstrated that countries with debt-to-GDP ratios higher than 90 percent have notably lower economic growth—their essential finding of the adverse impact of high indebtedness on growth has been supported by studies from the European Central Bank,[19] the International Monetary Fund,[20] and the Bank for International Settlements,[21] among others.[22] Research has also shown that high levels of debt inhibit economic competitiveness.[23]

Furthermore, a high debt environment limits the government's ability to respond to adverse economic conditions. A 2008 study published by the European Central Bank found that when a country's debt level is between 44 percent and 90 percent of GDP, the multiplier on economic activity is positive but likely below one. That is, the government spends a dollar but gets less than a dollar in growth. When debt passes 90 percent, fiscal multipliers go to zero;

no growth emerges from the increased spending. In these situations, an increase in deficits today reduces private spending by increasing the magnitude of future fiscal adjustment costs.[24]

CONCLUSION

As economists, we're concerned about the negative consequences of excessive debt. But neither we nor any other economist can identify at what point high debt levels become unacceptable to global credit markets. Nor can we reliably predict what form the resulting fiscal crisis will take. It could mean an inexorable deterioration of the US economy.[25] Or it could be more abrupt, with creditors losing faith and pulling their funds from the United States overnight, throwing the country into a vicious debt spiral, another deep recession, and ultimately a lower standard of living here and around the world.[26]

This outcome is not inevitable, but it grows dangerously more likely as policymakers delay taking action. Continued failure to reform the main drivers of current and future spending and debt—principally Medicare, Medicaid, Social Security, and the Affordable Care Act—will eventually force deep and highly destabilizing policy changes. Only by acting soon and maintaining a long-term commitment to controlling spending can policymakers avoid a potentially irreversible decline in Americans' standard of living.

NOTES

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10. CBO, *Updated Budget Projections*, Table 1.
11. CBO, *Updated Budget Projections*, Table 1; and CBO, *Budget and Economic Outlook*, Table H-3. Here and elsewhere, the entitlement figures are net amounts; gross entitlement spending is partially offset by various receipts such as Medicare premiums and certain user fees.
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17. CBO, *Long-Term Budget Outlook*, Table 1.1.
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