

RESEARCH SUMMARY

Fiscal Sustainability: High Stakes and Low Interest

The “debt ratio” is the federal government debt held by the public as a share of GDP. In recent years, however, economists and policymakers have shied away from using the debt ratio to measure fiscal sustainability, turning to new definitions instead. In “Fiscal Sustainability: High Stakes and Low Interest,” Veronique de Rugy and Jack Salmon argue that these new definitions of fiscal sustainability are misleading and understate the risks associated with the US government debt trajectory.

THE DEBT RATIO IS ON THE RISE

Policymakers have historically moved to limit the growth of public expenditures and restore long-run fiscal sustainability in the wake of previous increases in federal government debt levels. That no longer seems to be the case. Following the 2020 COVID-19 recession, US public debt exceeded the size of the economy for the first time since World War II, yet broad acknowledgment of the unsustainability of our fiscal trajectory is largely absent.

NEW METRICS OF FISCAL SUSTAINABILITY ARE BEING ADOPTED

In place of the debt ratio, new measures of fiscal sustainability focus on interest rates. The use of these metrics has gained traction among economists and is now having an actual impact on public policy decisions. The new sustainability measures have a number of important shortcomings because of their

- reliance on unrealistic assumptions that fiscal multipliers are large;
- failure to account for large primary budget deficits (current and projected);
- presumption that interest rates will remain low or decline further in the foreseeable future; and
- failure to account for declining real growth rates, especially in light of the adverse effects caused by a large and growing debt ratio as public borrowing crowds out private investment.

The new definitions of fiscal sustainability may well be politically motivated, benefiting special interests in the short term while burdening wider society over the long term.

POSSIBLE FUTURE CONSEQUENCES

If the federal government fully adopts new definitions of what it sees to be sustainable public finances, then our debt will likely continue to grow significantly larger than the annual output of our entire economy. As a result, the United States risks either long-run economic stagnation or a fiscal crisis in the future that could result in a massive recession, implementation of severe austerity measures, high unemployment, and wage stagnation.

In light of the current fiscal condition, the debt ratio remains a prudent metric for assessing the long-run costs and risks associated with the trajectory of our total stock of debt.