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EXECUTIVE SUMMARY

High and Rising US Federal Debt: Causes and Implications

by Karen Dynan

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Introduction

US federal debt currently stands at 98 percent of GDP, close to its highest level ever. The Congressional Budget Office (CBO) projects that under current law, federal debt will reach 115 percent of GDP within the next ten years and about 180 percent of GDP by 2053. This trajectory presents a significant economic challenge for the United States.

In this paper, Karen Dynan examines the main factors driving the unsustainable fiscal trajectory and describes how rising levels of federal debt will impose increasing economic costs and growing risks for the country. She argues that though feasible policy reforms exist to address these challenges, the policies necessary to put the rising federal debt on a sustainable path involve significant economic and political tradeoffs.

Understanding the US Fiscal Outlook

Dynan makes seven main points crucial for understanding the US fiscal outlook:

Population aging and rising health care spending are the primary factors driving the upward debt trajectory. The proportion of the US population aged 65 and older grew from about 12 percent in the first decade of the 2000s to 17 percent in 2023, with projections indicating a further increase to 22 percent by 2050. The aging population will require greater federal resources devoted to income support and health care. The CBO projects that, by 2053, Social Security outlays will rise by nearly 1 percent of GDP and spending on major federal health care programs will rise by 3 percent of GDP. These increases will drive the primary deficit (the deficit excluding interest payments) higher.

At 3 percent of GDP in 2024, the primary deficit is already much higher than its average of 1.5 percent over the past 50 years. Combined with an already-high level of debt and interest costs, ongoing large primary deficits would lead to a considerable additional increase in the total deficit and debt. A snowballing of interest costs as debt grows ever higher will compound the challenges—the CBO estimates that higher interest costs will increase the total deficit by 4.3 percentage points of GDP over the next 30 years.

Economic developments and policy changes from the past two decades have exacerbated current and projected levels of federal debt. US debt levels ballooned following two significant adverse shocks this century: the Great Recession that began in 2007 and the 2020 recession associated with the COVID-19 pandemic. These episodes led to less economic activity and taxable income, and at the same time, to increases in federal spending. Changes in economic policy have also increased the projected path of debt. A lasting downshift in revenues was brought about by major changes in tax policy, including the extension tax cuts from early in the first decade the 2000s and the further tax cuts enacted in 2017.

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Even under optimistic scenarios, US federal debt will reach historically high levels. Productivity growth, which leads to higher GDP growth, and the future trajectory of interest rates, which affects interest payments on the debt, will have major impacts on the long-term manageability of federal debt relative to GDP. In CBO forecasts, the debt-to-GDP ratio under an optimistic scenario for productivity growth is 44 percentage points lower in the early 2050s than its baseline assumption; under the pessimistic scenario, it is 47 percentage points higher than the baseline. CBO also projects optimistic and pessimistic scenarios for future average interest rates. Even under the optimistic scenarios, the US debt-to-GDP ratio is projected to reach levels in 2053 that are well above the historical range. These analyses underscore that even "good luck" with macroeconomic outcomes is unlikely to change the conclusion that federal debt is on an unsustainable trajectory.

The post-pandemic surge in inflation has been a small positive for fiscal sustainability but has also raised the risk of an economic slowdown. Consumer Price Index inflation increased from 1.3 percent in 2020 to 7.2 percent in 2021. Although it has moderated since, it remains above the Fed's target. Higher inflation influences the fiscal outlook through many channels. Its net effect on the primary (non-interest) federal deficit is likely to have been small, as higher non-interest spending is likely to be offset by higher tax revenue. Higher inflation (along with the sharp tightening of monetary policy in response) has increased interest rates on newly issued government debt, but it lowers the burden of existing debt because it raises nominal GDP. Thus far, the latter effect has dominated, resulting in a debt-to-GDP ratio somewhat lower than would otherwise be expected. However, if the restrictive monetary policy needed to curb this inflation results in a recession, the fiscal outlook could sharply worsen.

Projected increases in federal debt relative to GDP will pose increasing economic costs and risks. A higher level of borrowing by the government crowds out borrowing by households and businesses. This competition for funds drives up interest rates, and as a result, private investment in productive capital decreases, leading to lower future output and national income. High government debt also raises the risk of a fiscal crisis if investors become reluctant to lend money to the government because they fear the debt will not be repaid; in this case, government borrowing rates could rise suddenly and sharply as a result. Higher debt also comes with the costs of reduced "fiscal space," which constrains a country's ability to effectively address sudden domestic needs, such as economic crises, pandemics, or national security threats.

Determining a plausible policy framework for managing federal debt is difficult. There is no clear-cut optimal level of federal debt, nor is there a threshold that will automatically lead to a fiscal crisis. Rather, a crisis will occur when market participants come to believe the US will not honor its payment obligations on the federal debt. Balancing the overall budget (including interest costs) is more stringent than necessary to keep federal debt on a sustainable path, and it is so ambitious relative to the current outlook as to be unrealistic. An alternative approach would be to balance the primary budget, aligning revenue with non-interest spending. This approach would result in the government's debt-to-GDP ratio slowly falling over time.

Policy solutions to bring the structural deficit down to sustainable levels all involve trade-offs. Spending cuts and tax increases can keep the debt-to-GDP ratio at its current level, but the various options come with economic and political costs. At 11 percent of GDP today, spending on Social Security and Medicare is already above its historical average of 7 percent, and the aging population and excess growth of health care spending relative to GDP means that this spending is likely to rise to 15 percent of GDP by 2053. But simple plans to cut these programs uniformly—rather than according to the needs of recipients— would disproportionately harm some older Americans, especially those with lower incomes. Reductions in mandatory spending on younger Americans, particularly poor children and their families, could also hurt vulnerable people and reduce economic mobility. Cutting discretionary government spending may seem appealing in the abstract to policymakers—but such cuts become much less appealing when specific choices need to be made. Raising taxes is politically unpopular and could lead Americans to work less, save less, invest less, and innovate less.

Conclusion

The challenge posed by high and rising federal debt is significant but manageable as a matter of economics. The big problem is political. Most voters have little understanding of the composition of federal spending, the distribution of the federal tax burden, trends in federal spending and revenue, and the consequences of alternative budget decisions. That lack of understanding is natural, because voters have other things to do with their lives besides examine budget data. But, as a result, voters are dependent on their elected leaders to communicate the facts and tradeoffs the country faces, and our elected leaders have not done so effectively. Promises not to touch key elements of federal spending or revenue are popular, but they cannot all be realized if we are to put the budget on a sustainable path.

ABOUT THE AUTHOR

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Karen Dynan is a professor of the practice in the Harvard University department of economics and at the Harvard Kennedy School. She is also a senior fellow at the Peterson Institute for International Economics and the chair of the American Economic Association Committee on Economic Statistics. She previously served as Assistant Secretary for Economic Policy and Chief Economist at the US Department of the Treasury from 2014 to 2017. From 2009 to 2013, Dynan was vice president and co-director of the economic studies program at the Brookings Institution. Before that, she was on the staff of the Federal Reserve Board, leading work in macroeconomic forecasting, household finances, and the Fed's response to the financial crisis. Dynan has also served as a senior economist at the White House Council of Economic Advisers (2003-2004) and as a visiting assistant professor at Johns Hopkins University (1998). Her current research focuses on macroeconomic policy, consumer behavior, and household finances. Dynan received her PhD in economics from Harvard University and her AB from Brown University.

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