The Federal Fisc

The politics, policymaking, and public consequences of the U.S. government’s mounting debt—and how to cope with it

by Karen Dynan and Douglas Elmendorf

This year’s U.S. election campaigns offer competing visions for many aspects of American life, as candidates describe the federal programs they would launch or expand or shrink, and the taxes they would lower or (sometimes) raise. Rarely are the costs and revenues underlying those proposals made clear, and most voters are, reasonably enough, content with a general sense of candidates’ priorities. But ultimately the structures of federal programs and tax rules lead to amounts of federal spending, revenue, and borrowing, and those amounts matter for the national economy and for states, communities, and households. Here, we attempt to provide some larger context for evaluating the candidates’ plans—and their consequences for Americans’ financial future.

We Will Need to Act

We begin with the debt, which totaled nearly $17 trillion at the end of the last fiscal year, and GDP, roughly $21 trillion over that fiscal year: with a U.S. population of around 330 million people, that translates into about $64,000 of output and $51,000 of federal debt per capita.

Federal debt held by the public totaled between about 25 and about 50 percent of GDP between 1957 and 2008. (Some broader measures of federal debt include debt issued by one part of the government and held by another, rather than by the public; economists and budget analysts almost always focus on the measure we use.

Spending on health care is central to the long-term budgetary challenges. So it is especially useful to pair their essay with David Cutler’s nuanced explanations of why American health care costs so much: about $3.5 trillion per year (that’s the norm, before an emergency like COVID-19)—of which one-third is wasted. The sources of that waste, in terms of health value received for dollars spent, may surprise you. It has certainly proven resistant to political repair. Given the relatively poor results Americans receive for all they spend, fixing health care matters: for citizens’ wellbeing, the country’s fiscal soundness, and extending essential medical services to those who lack access now.

Dyan and Elmendorf’s analysis is especially timely and relevant. Spending on health care is central to the long-term budgetary challenges. So it is especially useful to pair their essay with David Cutler’s nuanced explanations of why American health care costs so much: about $3.5 trillion per year (that’s the norm, before an emergency like COVID-19)—of which one-third is wasted. The sources of that waste, in terms of health value received for dollars spent, may surprise you. It has certainly proven resistant to political repair. Given the relatively poor results Americans receive for all they spend, fixing health care matters: for citizens’ well-being, the country’s fiscal soundness, and extending essential medical services to those who lack access now.

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~The Editors

Three figures are paramount for considering any proposals for future federal spending and taxes.

• First, the ratio of federal debt held by the public to total output (gross domestic product, or GDP) was 79 percent at the end of the last fiscal year: the highest such ratio in the nation’s history except for six years during and right after World War II.

• Second, the ratio of federal revenue to GDP in the last fiscal year was 16.3 percent: the lowest such ratio in five decades except for two years in the early 2000s and four years following the financial crisis.

• Third, the average yield on 10-year Treasury notes in 2019 was 2.14 percent: the lowest annual yield in the past six decades, except for 2012 and 2016.
here, which nets out those cross-holdings.) That debt equals the
accumulation of past budget deficits less occasional surpluses. The
ratio of debt to output climbed sharply beyond its historical range
in the wake of the financial crisis at the end of the last decade, when
the severe recession and slow recovery (and the spending increases
and tax cuts enacted in response to the economic conditions) pro-
duced very large budget deficits. But today, even with the economy
growing fairly steadily and the unemployment rate falling below
4 percent, deficits are so large—roughly $1 trillion per year—that
debt continues to grow faster than the economy.

Moreover, under current policies, federal deficits will become
even larger over time, and federal debt will continue to expand faster
than the economy. According to Congressional Budget Office (CBO)
projections, debt will reach 98 percent of GDP in 10 years and 180
percent of GDP in 30 years. This projection assumes that almost all
the individual tax cuts enacted in 2017 will be allowed to expire as
scheduled after 2025; if, instead, those tax cuts are made permanent,
as happened in 2010 for most of the supposedly temporary individual
tax cuts enacted in 2001, then debt would climb much higher still.

The impact of debt on the economy depends on the combination
of spending programs and tax rules that fueled budget deficits.
Spending programs and tax rules that foster
economic growth lead to less debt relative to
the size of the economy than do programs and
rules that produce the same deficits but inhibit
growth. Estimating these effects, and projecting
all of the other variables that affect the federal
budget, are clearly challenging. But if projections by the CBO (and
other analysts) are even roughly correct, the trajectory of debt to
GDP is steeply uphill from here under current policies.

Some observers have worried that government debt cannot ex-
ceed some particular percentage of GDP without causing imme-
diate economic instability, but economists’ analysis suggests that
no definitive tipping point can be identified. Different countries at
different times seem able to support different amounts of govern-
ment debt, depending on their specific circumstances.

But few analysts think that federal debt could increase indefinitely
relative to the size of the U.S. economy, because economic activity
represents the resources that could be brought to bear to meet the
government’s obligation to pay interest on its debt and repay the
principal. Therefore, current policies must ultimately be changed.
Just to stabilize the ratio of federal debt to GDP, those changes
will need to be substantial. For example, given CBO’s projections, making the ratio of debt to GDP in 30 years equal to the ratio today would require a combination of revenue increases and spending cuts of roughly 2½ percent of GDP (or about $350 billion, or $1,700 per capita, today) in each year of the next 30. Accepting a higher target ratio 30 years hence would allow for smaller changes in the next few decades—but maintaining that ratio would require larger deficit reductions subsequently.

How to Act: Raising Revenue

Many different combinations of revenue increases and spending cuts could reduce budget deficits and thus debt—but we are not aware of any combination that is broadly popular.

- Spending. In 2019, total federal spending was equal to 21.0 percent of GDP (nearly $4.5 trillion, or close to $14,000 per capita), just a little above the 20.4 percent average of the preceding five decades. But the composition of federal spending has changed dramatically over time.

Spending has grown sharply relative to the size of the economy in a handful of large and generally popular programs: Social Security and the major healthcare programs—Medicare (for older and disabled Americans); Medicaid (for Americans of modest means and older Americans who have exhausted their resources—the program pays a substantial share of all U.S. nursing-home bills); the Children’s Health Insurance Program; and further subsidies for health insurance under the Affordable Care Act (ACA). Together, these programs cost about $6,600 per capita last year. (The additional spending attributable to the ACA is only about one-twentieth of federal spending for these programs.) Under current policies, spending for these programs will continue to grow much faster than GDP, driven by the retirement of the large baby-boom cohort, which increases the number of beneficiaries, and by continued increases in healthcare spending per capita at rates much faster than growth in GDP per capita. As the population continues to age and more Americans become beneficiaries of these programs, political support for cutting spending on them, already low, will wane further.

The remaining categories of federal spending apart from interest payments on the debt—other benefit programs, defense appropriations, and nondefense appropriations—are each currently equal to or smaller than their 50-year averages relative to the size of the economy. These other benefit programs (which include a portion of the earned income tax credit, food stamps, retirement benefits for federal employees, income security programs for veterans, etc.) cost about $1,700 per capita, and defense and nondefense spending each cost a little more than $2,000 per capita. (Interest payments are more than $1,100 per capita.) Even though spending in these areas is not high by historical standards, it certainly could be reduced—but the political appetite for doing so falls sharply when attention turns to specific programs. Between 2011 and 2018, even a conservative-led House of Representatives voted for no significant reductions in benefits apart from repeal of the ACA, and annual appropriations have consistently exceeded the overall limits Congress ostensibly imposed in 2011.

- Revenue. Federal revenue in 2019 was smaller relative to the size of the economy than its average over the past 50 years: 16.3 percent of GDP compared with 17.4 percent. Accordingly, federal revenue was a little under $3.5 trillion: close to $11,000 per capita. The difference from the long-term average stems from offsetting factors: economic shifts, legislated tax cuts, and bracket creep (which occurs as growth in inflation-adjusted household incomes pushes more income into higher tax brackets). Individual income taxes make up about half of total revenue and are close to their long-term average relationship with GDP. Payroll taxes have risen over time relative to GDP. And corporate income taxes and other revenue sources have declined relative to GDP.

Examining the tax burden among households is illuminating. The CBO allocates all federal taxes to households (for example, by attributing corporate profits taxes primarily to owners of capital) and then compares those taxes to incomes for representative households at different income levels. According to those estimates, federal taxes pay a substantial share of all U.S. nursing-home bills); the Children's Health Insurance Program; and further subsidies for health insurance under the Affordable Care Act (ACA). Together, these programs cost about $6,600 per capita last year. (The additional spending attributable to the ACA is only about one-twentieth of federal spending for those programs.) Under current policies, spending for these programs will continue to grow much faster than GDP, driven by the retirement of the large baby-boom cohort, which increases the number of beneficiaries, and by continued increases in healthcare spending per capita at rates much faster than growth in GDP per capita. As the population continues to age and more Americans become beneficiaries of these programs, political support for cutting spending on them, already low, will wane further.

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Looking ahead, the CBO projects that bracket creep and especially the scheduled expiration of almost all of the individual tax cuts enacted in 2017 would push up revenue significantly: to 18.0 percent of GDP in 2030—and higher thereafter. But under current law, spending for Social Security and the major healthcare programs will rise faster over the next decade, widening the deficit. Opinion surveys suggest that most people would prefer raising taxes to cutting spending on such programs.

We conclude that significant reductions in federal budget deficits ultimately should, and will, rely much more on revenue increases than on spending cuts. Raising revenue in a way that is both equitable and not very harmful for economic growth is a challenge, but a solvable one (and the topic for another essay).

When to Act: Later Rather than Sooner

The appropriate timing of actions to lower the growth of federal debt relative to GDP is an important and unsettled issue. The historically large amount of federal debt, combined with the continuing upward trajectory, suggests to some observers that reducing...
Federal policy should focus on changes to taxes and spending that promote the well-being of the many Americans who have benefited relatively little during the past few decades.

Budget deficits demand immediate action. But perhaps surprisingly, a broader look at the relevant evidence does not support that view. Rather, the very low level of Treasury interest rates implies that putting federal debt on a sustainable path is not as urgent as one might expect from the projected growth of debt alone—and, indeed, that sharply curbing deficits now would be a mistake.

Yields on Treasury securities soared in the 1970s and the beginning of the 1980s because of high inflation and the subsequent effort to drive inflation down, and they later subsided during the rest of the 1980s, 1990s, and early 2000s. Yields fell further in the financial crisis and Great Recession, and they have stayed low even as the economy has returned to essentially full employment. The current low level of rates cannot be attributed to mistakenly loose monetary policy, because rates are low even at long time horizons that are less influenced by current Federal Reserve decisions and because inflation remains below the Fed’s target. Moreover, the low level of interest rates is not a uniquely U.S. phenomenon but is common across many countries—despite a surge in government debt in many countries.

As this pattern of globally low interest rates has become more apparent, analysts have examined a large number of possible explanations. Candidates include a declining demand for investment dollars (stemming from falling prices for information technology and other factors), shifts in saving, and the safety and liquidity of government securities. Explaining past interest rates is a complex exercise, and forecasting rates is quite uncertain. Nonetheless, recent research implies that the key factors that have brought interest rates down will probably persist, and that rates will remain low by historical standards—an outlook that is quite consistent with readings from financial markets.

This new economic environment fundamentally changes the benefits and costs of reducing federal budget deficits. It is well understood that low interest rates change the dynamics of federal debt: for any given amounts of revenue and noninterest spending, lower rates mean that debt will compound more slowly. For example, CBO estimated a year ago that if interest rates were persistently a half-percentage point lower than the CBO projects, the government’s interest burden over the next decade would be nearly $1 trillion lower than the CBO projects.

It is less well understood that low interest rates change the desirable size of deficits and amount of debt for the government to issue. Recent research suggests that many of the factors that seem to have held down interest rates also make the optimal amount of federal debt larger than it would be otherwise.

This finding should not really be surprising: The most common economic cost attributed to high federal debt is that the government’s demand for loanable funds crowds out private borrowers who would have used those funds for capital investments that would boost future growth. Low interest rates suggest that loanable funds are not very scarce and that private investments with even moderate returns can be readily funded—so the government’s use of borrowed funds is not very costly to society. The next most common economic concern about high federal debt is that investors might suddenly worry that the debt will not be honored, and then try to sell their holdings in large quantities and push up interest rates sharply. But low interest rates suggest that investors are not very worried about that possibility.

Thus, with interest rates especially low, the optimal amount of federal debt is now much higher than in previous decades—so there is less urgency today to putting federal debt on a sustainable path than we and many other economists have argued in the past.

Plus, with interest rates so low, fiscal tightening now—to narrow the deficit—would threaten continued economic expansion. Increases in federal taxes and reductions in federal spending generally reduce demand for goods and services and thereby lower output and employment in the short run unless that effect is offset by cuts in the federal funds rate by the Federal Reserve. Because the Fed has little room to cut that rate today, a tighter budget now might decrease output and employment, with the attendant economic and social costs.

**Hedging Those Bets**

What are the disadvantages of delaying action to reduce budget deficits? One concern is that interest rates could jump upward unexpectedly. The danger of high interest rates is not great, because they could rise considerably from current levels and still remain below long-term averages, and because the global decline in rates stretching for almost 40 years implies that current low rates in the United States are hardly a fluke. To hedge bets, however, we support **lengthening the maturity** of federal debt issuance to lock in low long-term rates. Moreover, other than responding to future recessions, we think that **policymakers should not legislate any further increases in deficits**—which means that any policy changes that increased spending or reduced revenue would need to be combined with other policy changes with offsetting budgetary effects, an approach known in previous years as “paygo.”

A second concern is that some policy changes should be enacted well before they take effect, so that people whose benefits or taxes would need to be combined with other policy changes with offsetting budgetary effects, an approach known in previous years as “paygo.”
Alec Smith died of diabetic ketoacidosis, though it is probably fairer to say that he died from high health-care costs. The 26-year-old from Rochester, Minnesota, had just moved out of his parents’ home and didn’t have enough money to afford his insulin. He decided to ration his remaining supply until his next paycheck, a week later. Alas, he was not able to make it. Alec died alone in his apartment, vomiting and having difficulty breathing, from a condition that never should have occurred. Alec’s story is extreme in its outcome, but not in its outlines. Nearly half of Americans say they have delayed or skipped medical care because of the cost. People who face higher costs for medical care are diagnosed with cancer at later stages of the disease and take fewer medications. Even the very sick use less care when their out-of-pocket costs rise. Health suffers.

The United States has many problems in medical care, from the large share of the population still uninsured (about 10 percent of us) to one of the lowest life expectancies in the developed world. Underlying all these problems is the high cost of medical care. We do not guarantee adequate access to medical care because we cannot figure out how to pay for it.

The harm from high medical spending goes well beyond the medical sector. Many firms have outsourced low-wage workers because providing them health benefits is too expensive. Government spending for schools and environmental programs are starved because resources go to health care instead. Warren Buffett called medical costs the “tapeworm of American economic competitiveness.” Oncologists have invented a term, “financial toxicity,” to consider along with biochemical toxicity in deciding on the appropriate treatment.

Whatever candidates for office do (or do not) say, members of the public ought to bear in mind a few principles about our national government’s finances. We think about them this way:

- Federal debt cannot rise indefinitely relative to the size of the economy, as it would under current policies, so changing those policies to reduce budget deficits will become necessary.
- Given the amount of federal revenue being collected relative to the size of the economy and households’ incomes, and given the amount and composition of federal spending, those future changes should rely more on revenue increases than spending cuts.
- But the changes are less urgent than one might deduce from the projected path of federal debt, because interest rates will probably remain well below their long-term averages.

Accordingly, the focus of federal budget policy over the next few years should not be deficit reduction but deficit-neutral changes to tax rules and spending programs that promote the economic and social well-being of the many Americans who have benefited relatively little from national economic growth during the past few decades.

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