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Fiscal sustainability: what to worry about and what not to

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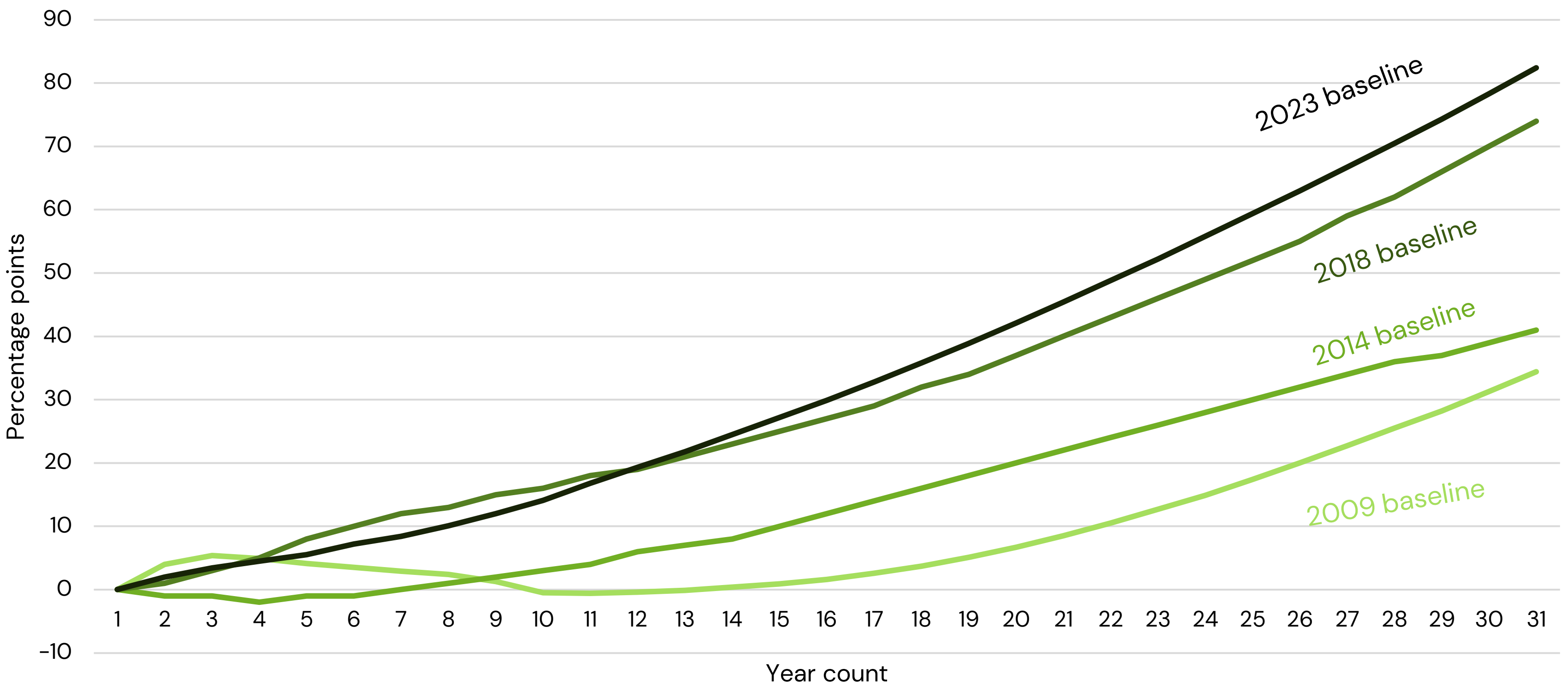
1. The projection of ever-rising federal debt is not new.

Increase in federal debt as a share of GDP relative to first year of long-term budget projections



Source: CBO's June 2009 report *Long-Term Budget Outlook*; CBO's July 2014 report *The 2014 Long-term Budget Outlook*; CBO's June 2018 report *The 2018 Long-Term Budget Outlook*; CBO's June 2023 report *The 2023 Long-Term Budget Outlook.*

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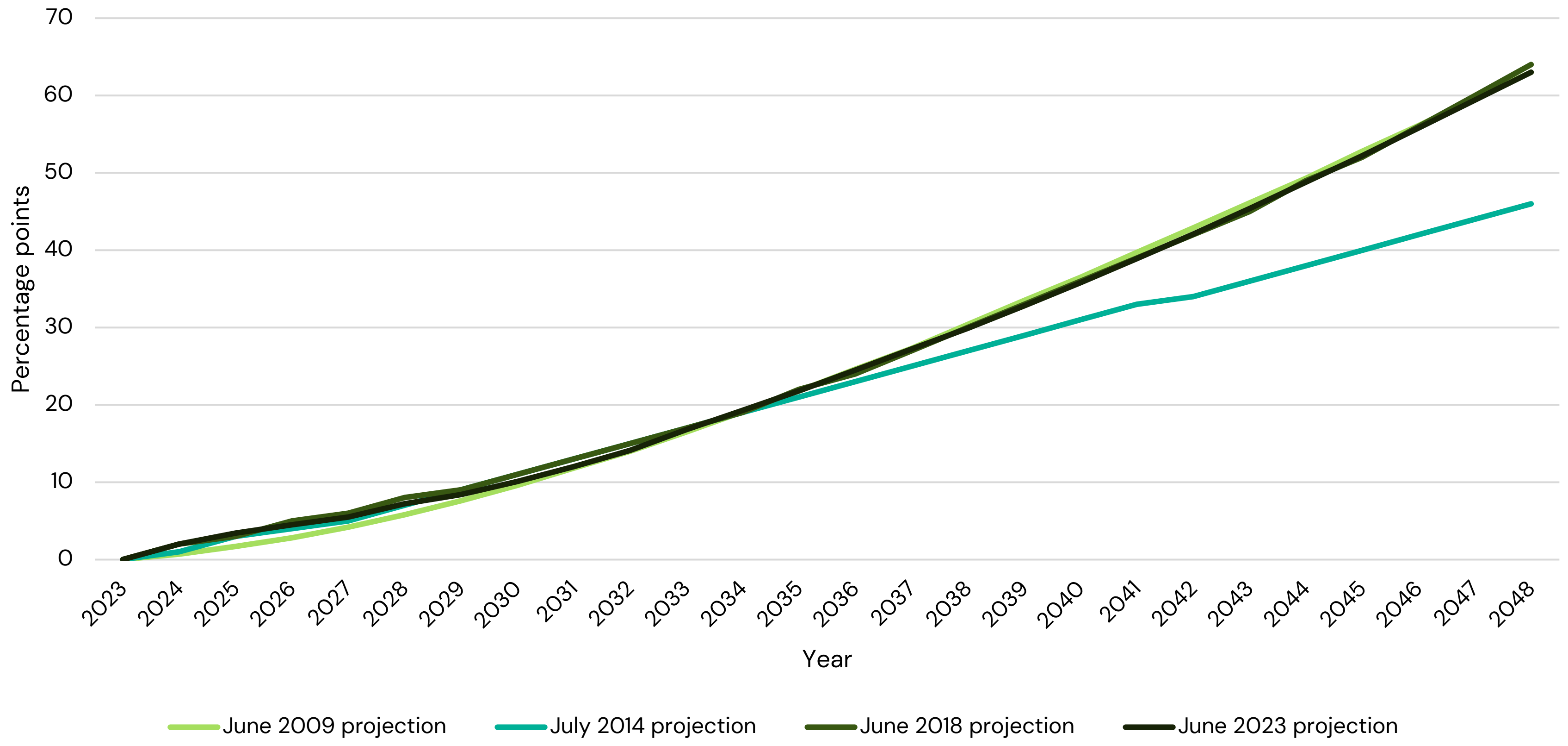
2. The projected increase in federal debt as a share of GDP over next 25 years is remarkably consistent.

Increase in projected federal debt as a share of GDP relative to 2023, 2023-48



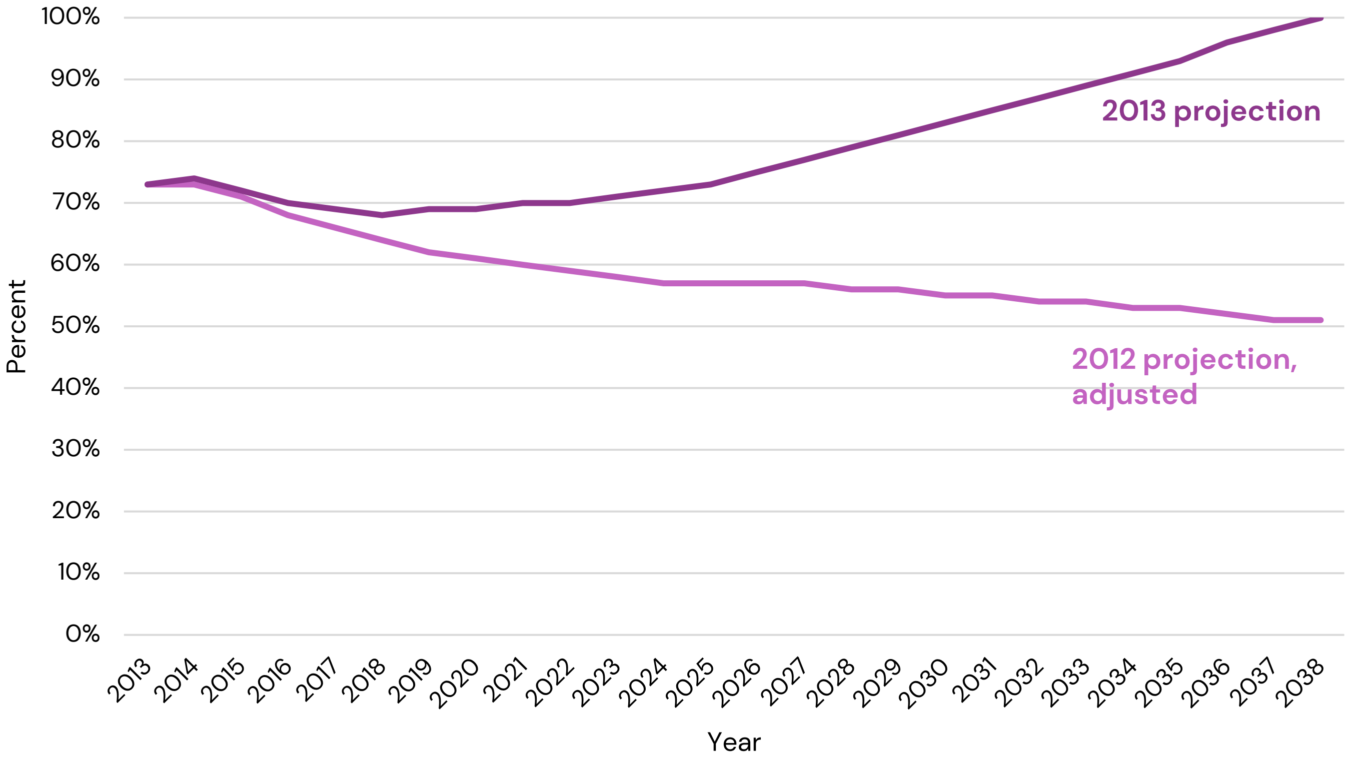
Source: CBO's June 2009 report *Long-Term Budget Outlook*; CBO's July 2014 report *The 2014 Long-term Budget Outlook*; CBO's June 2018 report *The 2018 Long-Term Budget Outlook*; CBO's June 2023 report *The 2023 Long-Term Budget Outlook.*

3. Tax policy significantly affects projected debt.

In January 2013, Congress passed the American Taxpayer Relief Act.

After passage, projected debt as a share of GDP after 30 years increased by roughly 50 percentage points.

Federal debt held by the public as a percentage of GDP, 2013-38



Source: CBO's September 2013 report *The 2013 Long-Term Budget Outlook* (Figure A-1).

Notes: For both projection years, the extended baseline is plotted. The extended baseline generally adheres closely to current law, following CBO's 10-year baseline budget projections and then extending the baseline concept for the rest of the long-term projection period. For comparison with the projections published in 2013, CBO *adjusted* its 2012 long-term projections to reflect revisions by the Bureau of Economic Analysis to historical estimates of GDP that were published by BEA between the 2012 and 2013 budget projections.

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4. Federal borrowing crowds out private investment.

To the degree that private investment is ultimately lower as a result of greater federal borrowing (termed “crowding out”), future GDP will be lower.

CBO uses a range of estimates to calculate the effect of crowding out, but for the central estimates:

> When the deficit goes up by 1 dollar, private saving is estimated to rise by 43 cents (national saving falls by 57 cents), and net capital inflows rise by 24 cents, ultimately leaving a decline of 33 cents in investment.

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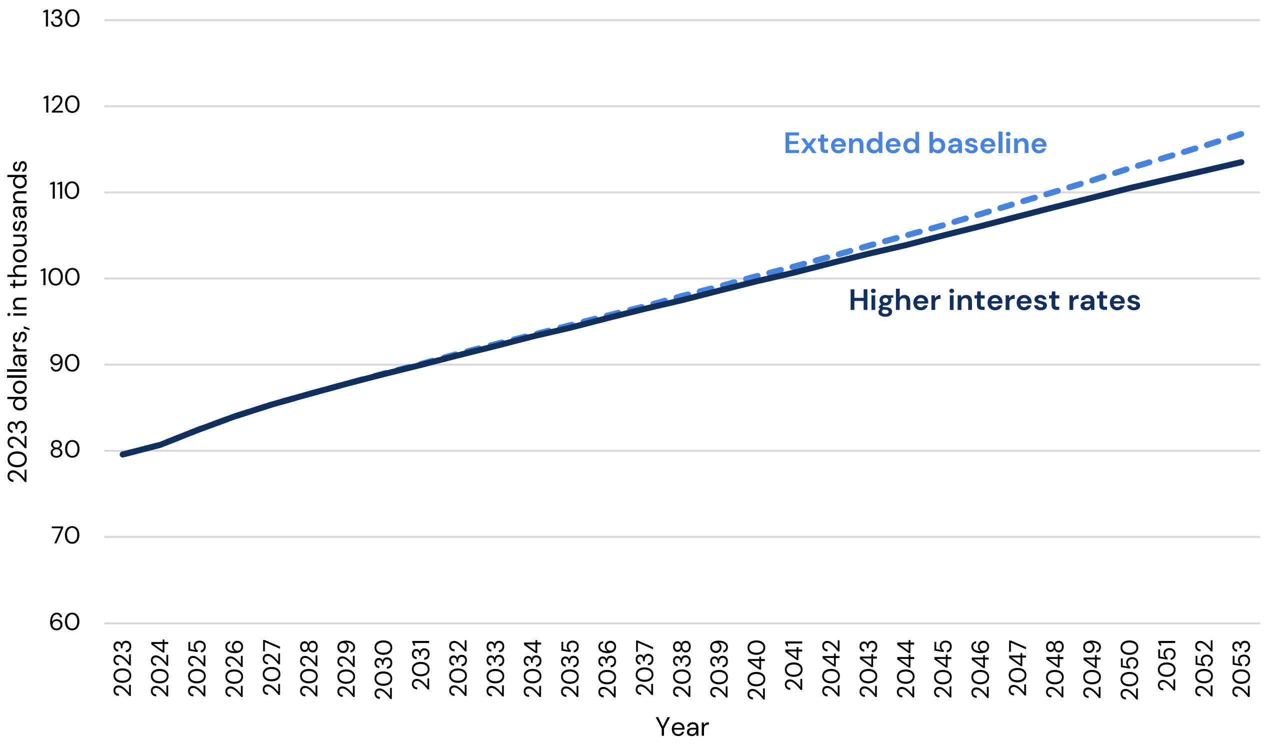
5. Significant increases in projected debt modestly lower projected income.

Real GNP per person under baseline and higher-debt scenario, 2023-53



Source: CBO's July 2023 report *The Long-Term Budget Outlook Under Alternative Scenarios for the Economy and the Budget.*

Notes: CBO's long term budget projections, referred to as the **extended baseline***, generally follow current law. Projected debt as a share of GDP rises to 181 percent in 2053.* Under the ***higher Interest rate scenario****, the average interest rate on federal debt was boosted above the rate underlying CBO's extended baseline by a differential that starts at 5 basis points in 2023 and increases by 5 basis points each year (before macroeconomic effects are accounted for). Projected debt as a share of GDP rises to 231 percent in 2053.*

CBO analyzed a scenario where the debt-to-GDP ratio was 50 percentage points higher after 30 years than in the baseline (because interest rates on federal debt were higher for reasons unrelated to productivity: 5.8% instead of 4.0% in 2053).

Higher federal borrowing leads to crowding out of private investment.

As a result, projected GNP per person would rise by 43% instead of 47% over next 30 years.

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6. Conversely, a policy that reduces debt while additionally encouraging work and saving only modestly increases GNP

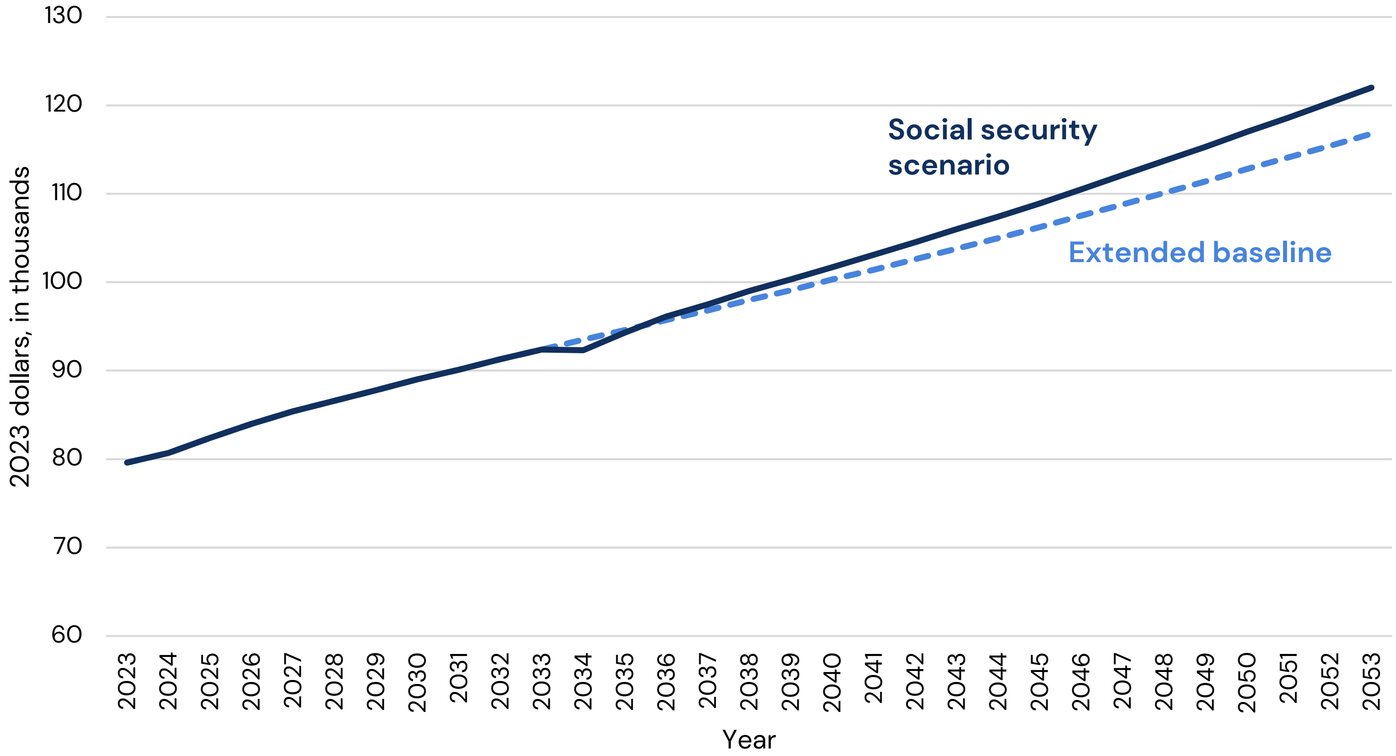
CBO analyzed a scenario where the debt-to-GDP ratio was 50 percentage points lower after 30 years than in the baseline (because Social Security benefits were cut by between 25% and 28%).

This leads to:

- Higher saving rate
- Greater labor supply
- Crowding in of private investment

As a result, projected GNP per person would rise by 53% instead of 47% over next 30 years.

Real GNP per person with lower social security benefits, 2023-53



Source: CBO's July 2023 report *The Long-Term Budget Outlook Under Alternative Scenarios for the Economy and the Budget.*

Notes: CBO's long term budget projections, referred to as the extended baseline, generally follow current law. Projected debt as a share of GDP rises to 181 percent in 2053. Under the Social Security scenario, Social Security benefits are limited to the amounts payable from dedicated funding sources. Projected debt as a share of GDP rises to 132 percent in 2053.

7. What people are really worried about is a fiscal crisis

Much more significant concern is risk of a fiscal crisis, defined as an abrupt and very large increase in interest rates likely coupled with a large decline in the value of the U.S. dollar.

A crisis is likely precipitated by lenders to federal government worrying about default risk and very high inflation.

Political dysfunction or anticipated dysfunction does. The political dysfunction that some have imagined would be for the purpose of “dealing with” the debt. Neither defaulting nor inflation would create fiscal sustainability given future budget pressures.

Still, alongside debt ceiling crises or other threats to financial stability, changes in laws that sharply steepen projected debt may be seen as an indication of dysfunction.

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8. Takeaways

Historical patterns suggest that rising debt as a share of GDP reduces the size of the economy. Those effects are modest relative to overall economic growth.

Nonetheless, funding federal spending through well-designed taxes instead of federal borrowing increases income in future years.

High and rising debt, on its own, *does not create the risk of a fiscal crisis*.

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