BORROWED TIME:

Addressing Unsustainable Public Debt Levels – Before It's Too Late

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INTRODUCTION

> *"I believe there is now clear recognition among well-informed observers that we must find a way to address the debt problem before it gets beyond our control."*

In the spring of 2024, I gave a presentation at CoBank's regional customer meetings about unsustainable public debt in the United States and the long-term dangers it poses to our country. At each meeting, attendees sought me out afterward to express their concern about this issue and to ask about realistic ways to address it. Many requested copies of my slides so they could share them with management and boards at the companies they lead.

Based on the response it received, I am reproducing the presentation here for the benefit of anyone who is interested in this issue, including both my charts and commentary. While the problem of public debt is certainly not new, it has taken on heightened urgency over the last two years as the Federal Reserve has raised interest rates, making federal borrowing much more expensive than it was before. I believe there is now clear recognition among well-informed observers that we must find a way to address the debt problem before it gets beyond our control.

Almost all the data used to create the charts that follow comes from the Congressional Budget Office and other official sources. Where we have done our own projections, we have worked with the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution. I am grateful for the help of David Wessel, director of the Hutchins Center, for his thoughtful perspective and guidance in putting this presentation together.

Sincerely,

Tom Halverson

Tom Halverson
June 2024

U.S. PUBLIC DEBT

The United States' public debt load has grown substantially over the past two decades.

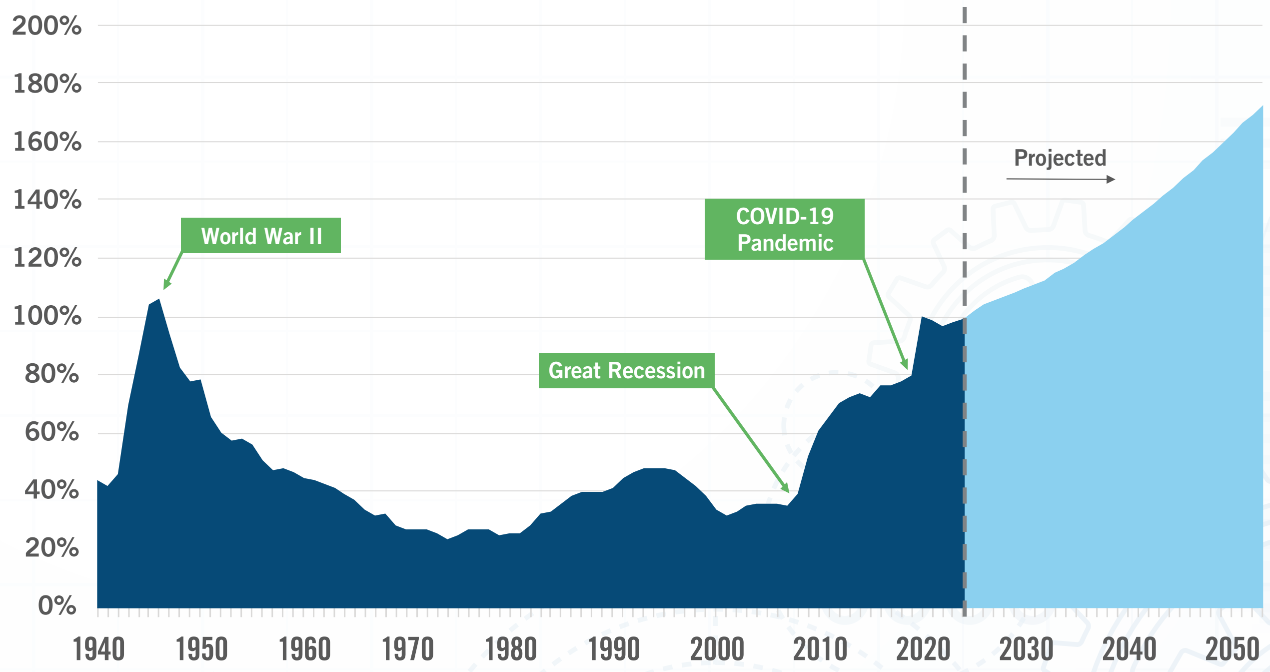
Back in 2000 it was only 34% of GDP. Today, it is approximately 100% of GDP. In fact, the U.S. is now at the same level of public indebtedness as it was at the end of World War II, when we had borrowed enormous amounts of money to fund the war effort and defeat the existential threats to national survival posed by Nazi Germany and the Empire of Japan. Major recent drivers of increased debt have been the Great Recession of 2008 and the COVID-19 pandemic of 2020. The federal government borrowed heavily in response to both of those crises to provide fiscal support to our distressed economy.

According to official projections, the trajectory of debt-to-GDP over the next 30 years will continue to rise relentlessly, year after year, reaching over 170% in 2053.

There is no objective constraint for the sustainability of public debt – no established level where a country's debt suddenly becomes "too high" and causes a financial calamity. However, it would be wise to be concerned now that we are at 100% and climbing rapidly.

It's not an overstatement to say that we are in uncharted territory. As a nation, we have no experience with debt levels of this magnitude under macroeconomic conditions like those prevailing today. We have no old tried-and-trusted playbook we can dust off and re-use to deal with this problem.

U.S. Federal Debt as a Share of GDP



Source: Congressional Budget Office

KEY RISKS

We do know quite well what the risks are if we don't figure out a way to address the public debt problem.

Bond Vigilantes: Coined in the 1980s by economist Ed Yardeni, the term "bond vigilantes" describes bond market investors – the people and institutions who loan the U.S. government money every time they buy U.S. treasury securities. They include banks, pension funds, insurance companies, foreign countries, individual investors and anyone else who invests in government bonds. Whenever these diverse investors perceive that inflation risk or credit risk is increasing, they demand higher yields to buy that risk. When that happens, the cost of borrowing goes up for the government – and the rest of the economy as well since all other interest rates in our economy are directly or indirectly indexed to treasuries.

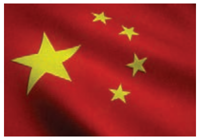
Government Budgets: Interest expense is not optional. Higher debt levels mean that net interest payments consume an ever-increasing share of federal spending, and the less money there is to invest in important government programs – defense, infrastructure, farm programs, etc.

Interest payments on the federal debt already cost an enormous amount of money – $870 billion dollars in 2024. Believe it or not, that's more than we will spend this year on national defense. In two years' time interest expense will exceed $1 trillion annually.

Reserve Currency Status: A longer-term risk is the global status of the U.S. dollar. Today the dollar is the reserve currency for the entire world. The U.S. government, and all Americans, derive huge benefits from that fact, including the unique privilege of borrowing in our own currency. We definitely do not want to lose that much-coveted competitive advantage. If we're not careful, we could debase our currency such that the world might eventually seek other alternatives to the U.S. dollar.

Lower Economic Growth: The more government borrowing increases, the more it crowds out investment in the private sector that otherwise would be available to fund investments that drive productivity and job growth. If economic growth rates are depressed for a sustained period, that translates into less opportunity, less prosperity and lower quality of life for all of us over the long term.

Black Swan Events: Though they are rare by definition, so-called "Black Swan events" do happen over time with a fairly high degree of regularity – e.g. the September 11, 2001 terrorist attacks; the Great Recession of 2008; the COVID-19 pandemic in 2020. We need to preserve our nation's fiscal flexibility to respond to Black Swan events when they occur. Excessive indebtedness reduces that flexibility and the ability of our government to respond appropriately to future crises.



Foreign Holders: Today, over $7 trillion of U.S. public debt is held by other nations, about a quarter of the total debt outstanding. About $1 trillion of that is owned by the People's Republic of China alone. Many people worry that this debt could be weaponized in response to a geopolitical event – having a flood of T-bills dumped into the capital markets and driving bond yields higher.

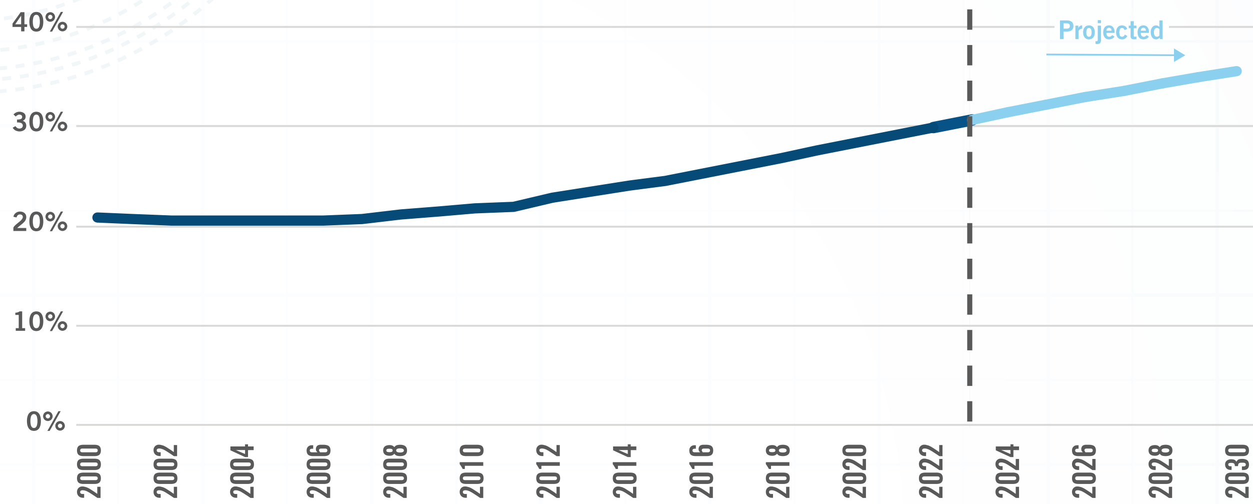
DEFICIT DRIVERS

Together, the two charts on this page explain why federal debt in the United States will continue to grow so quickly unless something is done about it.

The chart on the top shows the number of retirees in the U.S. in relation to the number of people of working age. By 2030 it will reach 35%, compared to about 20% in the year 2000. We are an aging society, which is expensive for a government that provides both retirement income and health care for senior citizens.

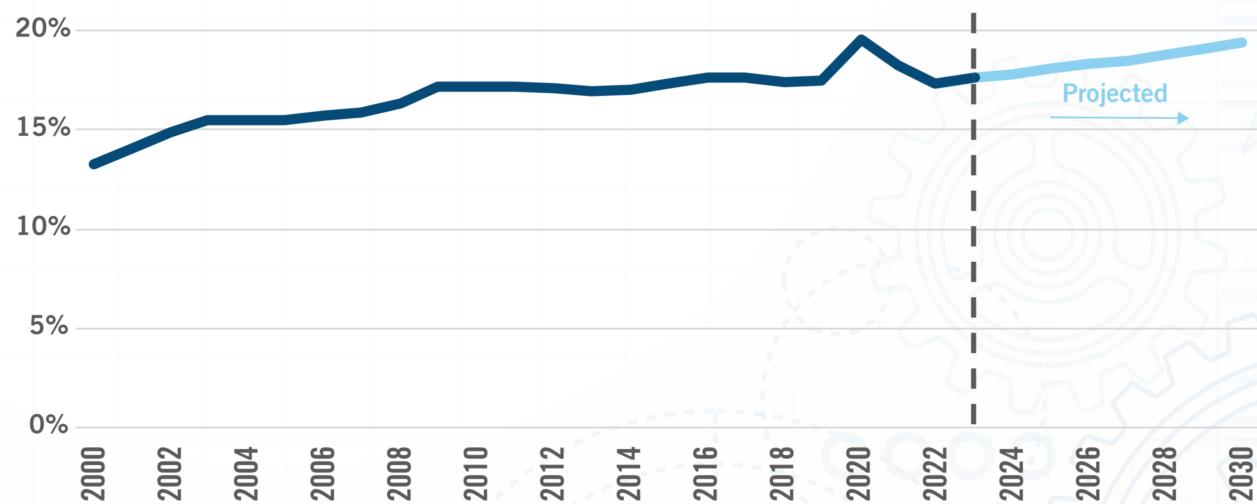
The chart on the bottom shows health care spending as a percentage of GDP, which also continues to rise steadily. The combination of health care inflation and societal aging is brutal from a budgetary standpoint. It is the primary driver of our debt-to-GDP ratio, and why we're on the path to 170% by 2050.

People 65+ / U.S. Working Age Population



Source: Census Bureau

Health Care Spending as a Percent of GDP



Source: Congressional Budget Office

RISING PUBLIC DEBT COSTS

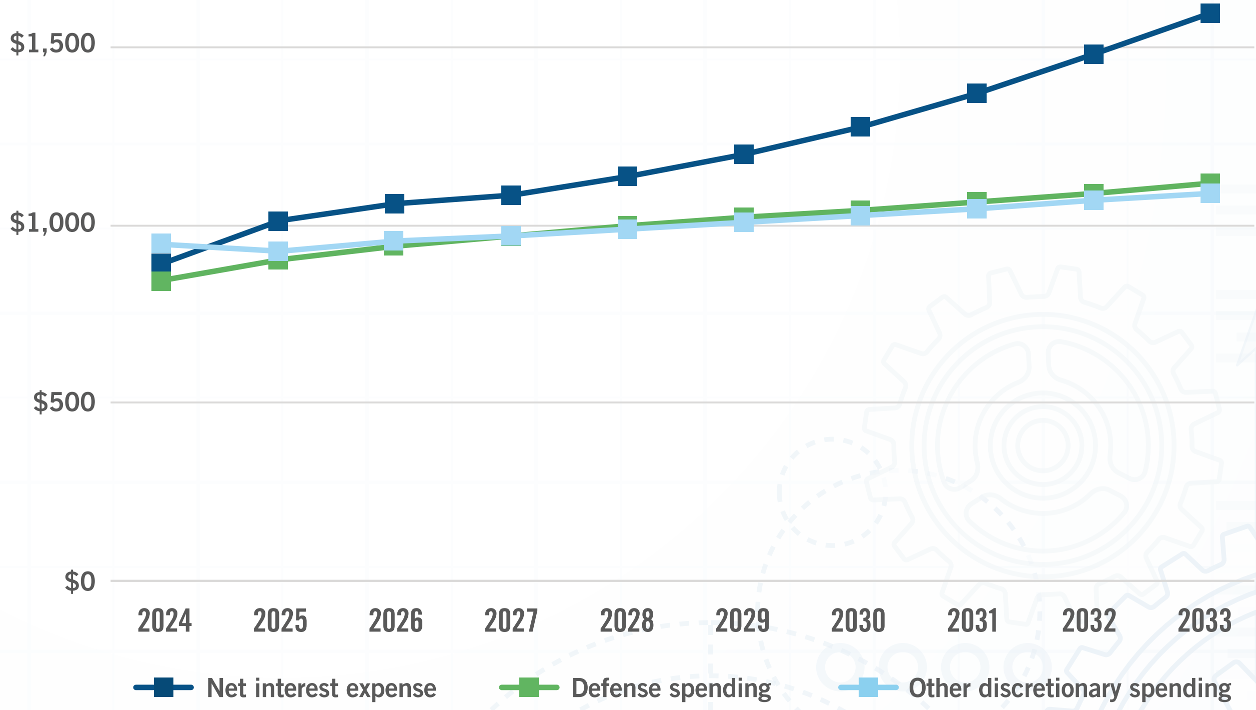
This chart shows the projected cost of interest on the federal debt relative to "discretionary" government spending – meaning spending outside the realm of entitlements.

According to official estimates, interest expense will begin to exceed U.S. defense spending for the first time in history in 2024. The "other discretionary spending" category includes all other non-defense programs of the federal government. It too will be surpassed by interest expense starting in 2025.

As shown on the chart, net interest expense will rise much more quickly than discretionary spending over the next 10 years, exceeding $1.5 trillion in 2033.

Net Interest vs. Discretionary Spending

$ in billions



Source: Congressional Budget Office

FEDERAL REVENUES AND OUTLAYS

This slide depicts the income statement of the U.S. federal government – revenues and outlays broken into their major categories.

Revenues: All the revenues of the federal government can be broken down into four categories: individual income taxes, payroll taxes, corporate income taxes, and other taxes. ("Other" is a catch-all that includes things like estate taxes, excise taxes, etc.) In aggregate, these taxes generated about $4.8 trillion in revenue for the 2023 fiscal year.

The single biggest source of revenue is individual income taxes, which account for about 52% the total. Payroll taxes account for another 32%. Corporate income taxes and other taxes together account for only about 16%.

There is no way to solve the federal debt problem on the revenue side without hitting up individual taxpayers. The other sources of revenue simply aren't big enough to move the needle.

Outlays: Federal spending added up to $6.3 trillion in 2023.

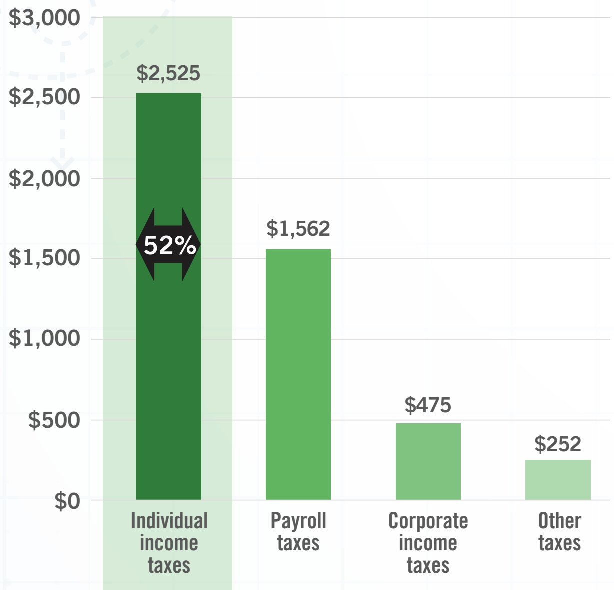
Medicare, Medicaid, Social Security and other "mandatory" benefits together accounted for 63% of federal spending last year.

In short, it's all about entitlements. If we are going to use spending cuts to solve federal deficits, then entitlements are going to have to be on the table. There is no other plausible way to get there.

The Deficit: Compared side-by-side, the difference between federal revenues and outlays – demarcated by the black dotted line – is the federal deficit for that year, the amount that needs to be covered with borrowing and that gets added to the total public debt. As you can see, it exceeded $1.5 trillion in 2023 alone.

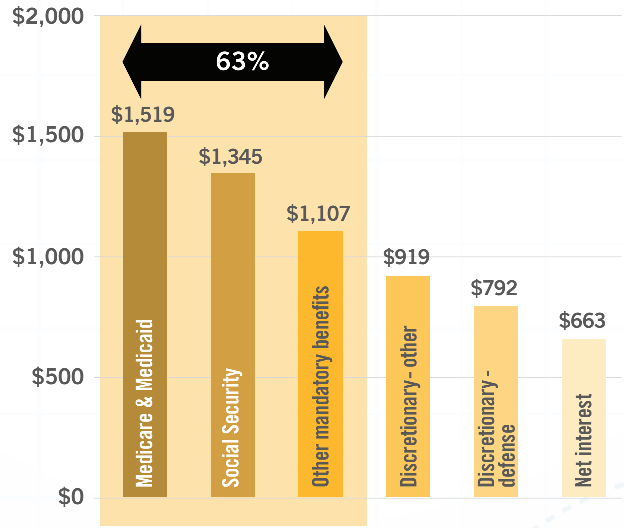
Federal Revenues by Category

2023 – $ in billions



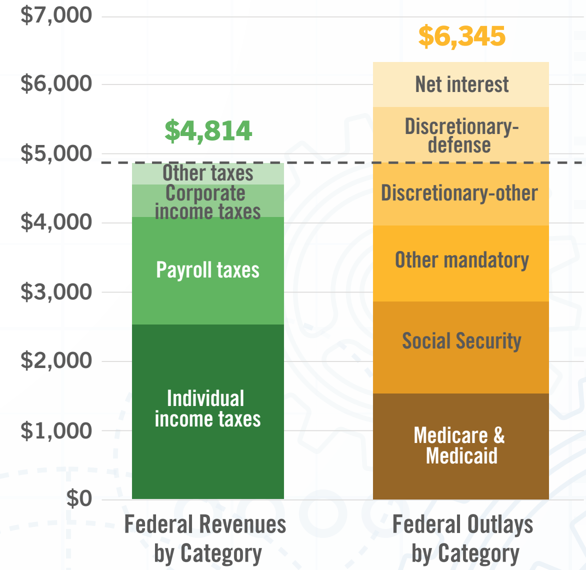
Federal Outlays by Category

2023 – $ in billions



The Deficit

2023 – $ in billions



Source: Congressional Budget Office

DEFINING A SOLUTION

So how do we solve this problem?

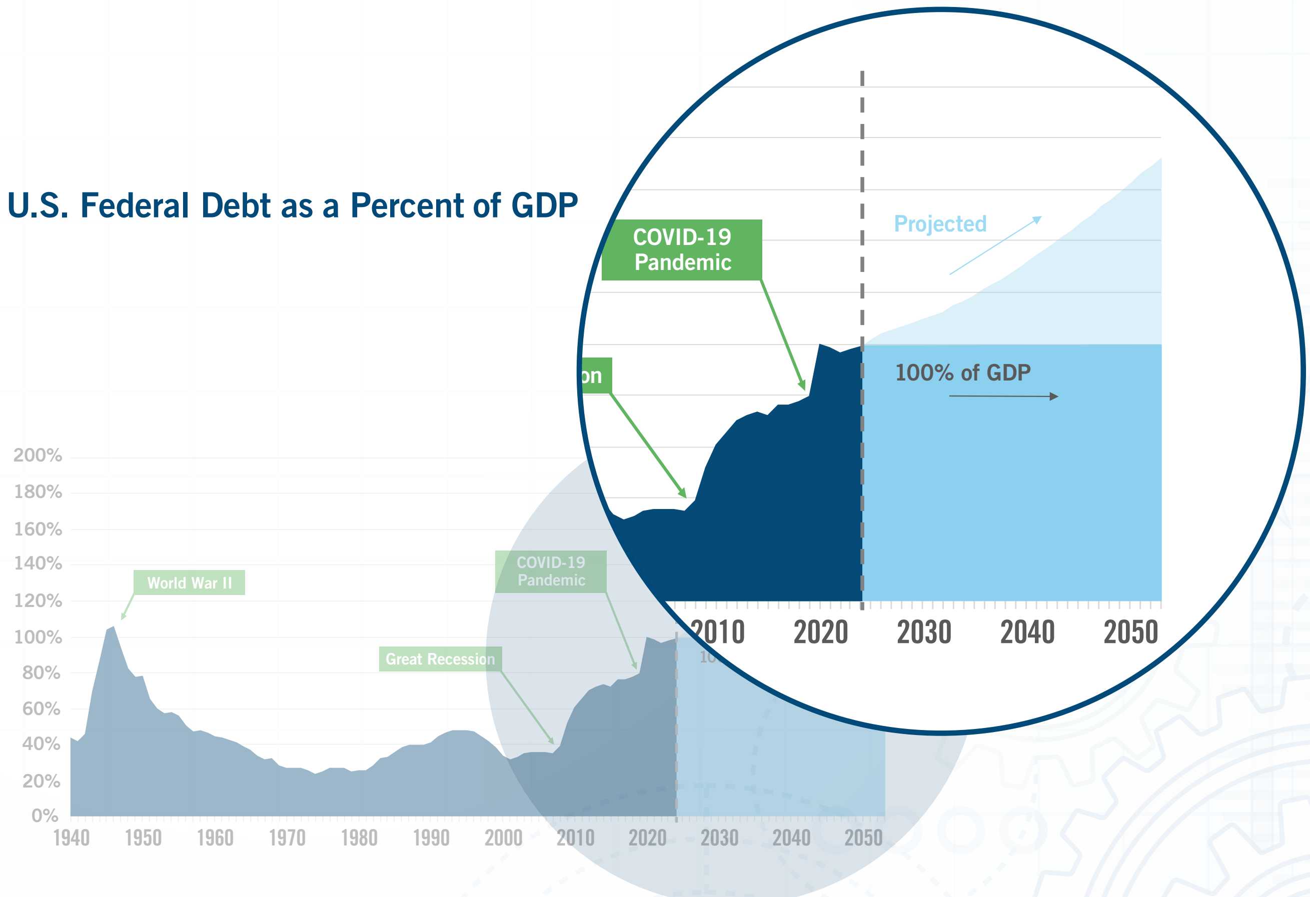
To answer that question, the first thing you have to do is define what a credible and reasonable solution might look like – an achievable target to aim for. The solution cannot be reasonably defined as eliminating public debt altogether over the long term or even to balance the federal budget. That would not be realistic, nor is it necessary to secure our financial future.

Instead, the solution needs to be defined as stabilizing public indebtedness at a level that is comfortably financeable and in proper proportion to the size of the overall U.S. economy.

Working with David Wessel at the Brookings Institution, we decided that maintaining a debt-to-GDP ratio of 100% over the long term is a reasonable goal that we could realistically shoot for. Once we established that as our reasonable and achievable objective, we then worked on what it would take to achieve that both in terms of incremental revenues (meaning taxes) and cuts in spending.

The results are shown on the pages that follow.

U.S. Federal Debt as a Percent of GDP



Source: Congressional Budget Office

STABILIZING DEBT / GDP AT 100% (REVENUES)

If our goal is to maintain the debt-to-GDP ratio at 100%, and if we started today, what would it take to do that using tax increases alone?

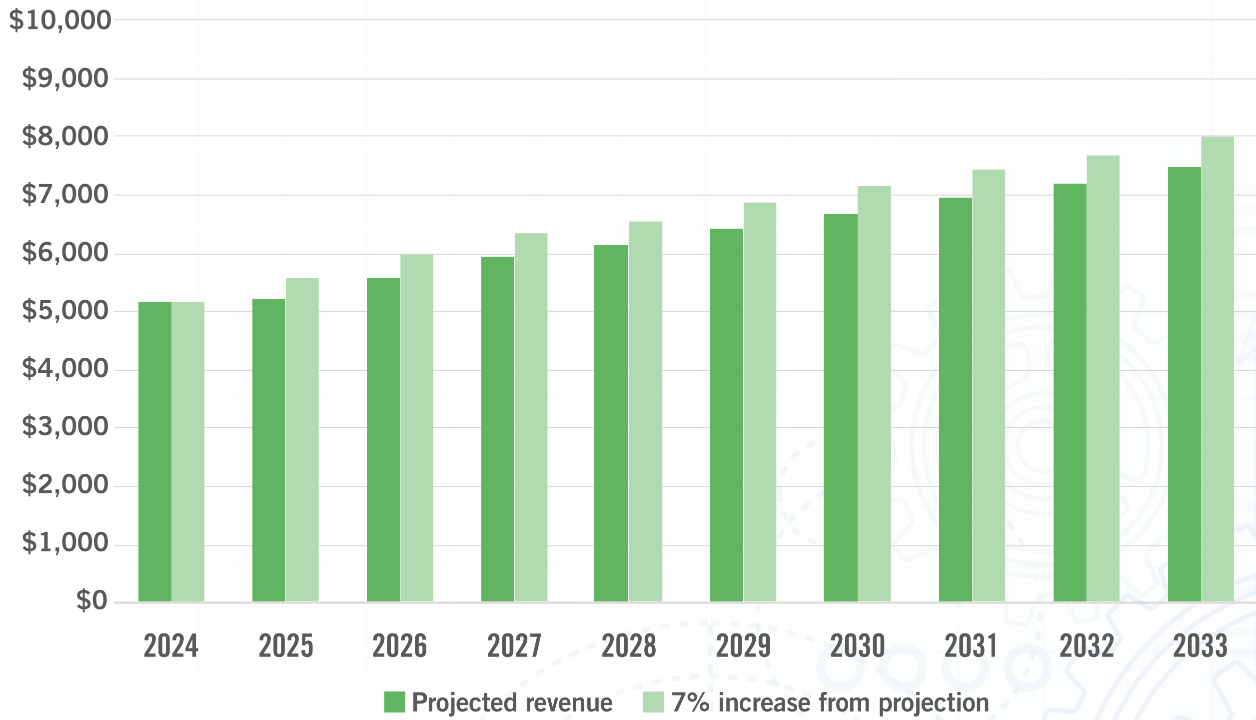
Based on the math we did, and assuming the official estimate for average real GDP growth of 2%, we could achieve our objective by raising taxes across the board by about 7%. For the math to work, those tax hikes would need to occur in 2025.

Whether this is good news or bad news probably depends a bit on your disposition and your outlook on life. Would this be painful and highly unpleasant for many taxpayers, especially middle- and upper-income taxpayers who carry the lion's share of the tax burden? Absolutely.

Would it be impossible? Absolutely not. The U.S. economy could absorb this level of increased taxation without incurring structural damage or harming its ability to grow on a sustained basis.

Federal Revenues – 10-Year Projection

($ in billions)



Source: Congressional Budget Office; CoBank analysis

STABILIZING DEBT / GDP AT 100% (OUTLAYS)

Now let's look at solving the problem using spending cuts.

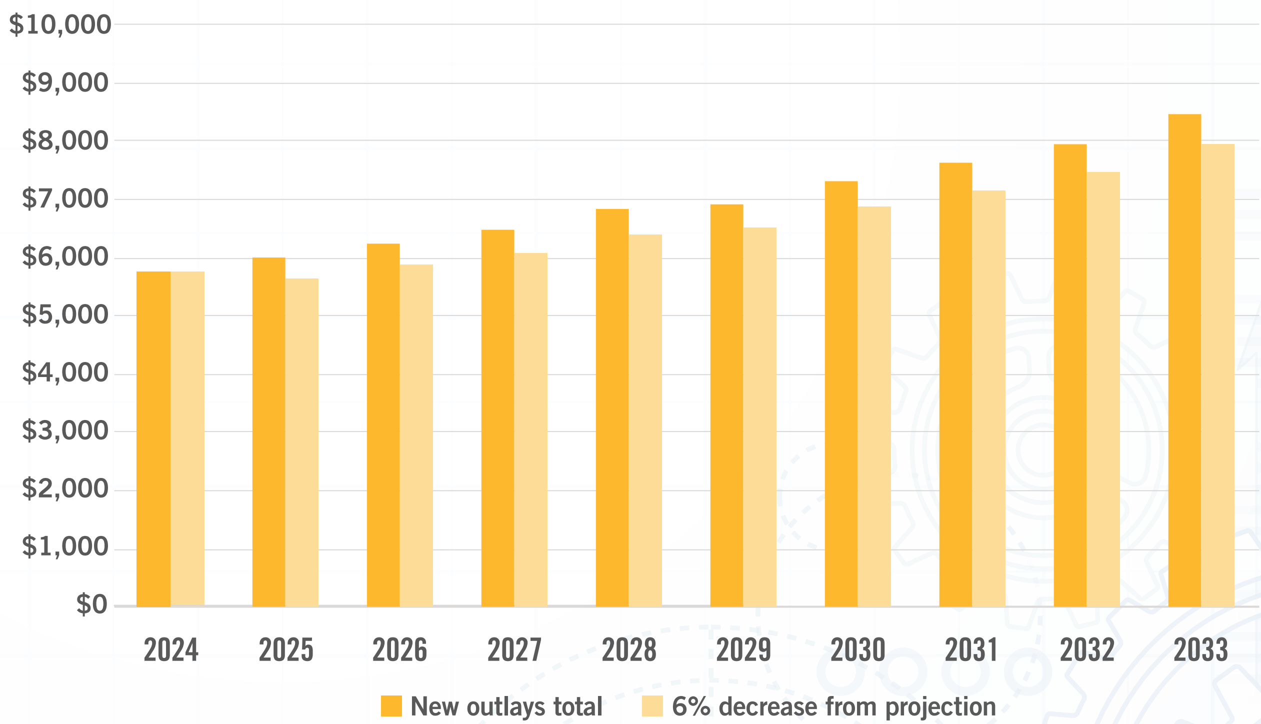
To cut our way to our objective we would need to reduce federal expenditures by about 6%. There is no way to do this without cutting entitlements, which would be very unpopular. At the same time, we are not really talking about draconian reductions, in the true sense of that word.

And – of course – the reality is that we would not solve this problem only by cutting spending, or only by raising taxes. Realistically, we would rely on a combination of both so that the economic impacts are spread across the population and the burden is shared between taxpayers and people who rely on government for health care, basic income and other forms of public support.

Importantly, this problem gets harder and harder to solve over time if you don't get started. Every year that goes by without taking action requires higher tax increases and bigger spending cuts to have the same impact. If we genuinely care about this problem, we need to deal with it soon and not procrastinate.

Federal Outlays – 10-Year Projection

($ in billions)



Source: Congressional Budget Office; CoBank analysis

WANTED: POLITICAL WILL

"Responsible and well informed citizens – people in both political parties who care about the future of the country – must demand that our political leaders seriously address this problem."

That brings us to the big question: How do we get our political leaders to take debt and deficits seriously?

There is no easy answer to that question. Making difficult choices is not something politicians do naturally, even in normal circumstances. It's even harder in a presidential election year, when the country is so divided and candidates are competing for the affection of the voting public.

However, nothing will change in Washington to address this issue unless we as voters make it a priority. Responsible and well informed citizens – people in both political parties who care about the future of the country – must demand that our political leaders seriously address this problem. Otherwise it will continue to be ignored and worsen.

In one of his earliest published speeches, Abraham Lincoln once said: "As a nation of free men, we must live through all time, or die by suicide." He wasn't talking about deficits, but his words are nonetheless applicable here. It is within our power to solve our debt problem, but we must choose to do so.

At the end of the day our fiscal future is a political problem as much as it is a math and economic one. Solving it inevitably requires adopting policy measures that are painful, unpopular and sustained in order to secure a better future for our country, our children and our grandchildren.

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