



The Takeaway

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Trade, Economics, and Public Policy

A Time for Political Courage The Federal Debt Crisis in 2014

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Like many Americans, Uncle Sam has a bad habit of spending more than he earns. As Figure 1 illustrates, the federal government's total expenditures exceeded its total revenues in 36 of the last 40 years. In 2012, federal government revenues were 16% of gross domestic product (GDP) and expenditures were 23%, leaving a deficit equal to 7% of GDP or \$1.1 billion.

Each year of deficit spending results in new borrowing and a higher and higher national debt. In turn, the growing national debt increases the interest payments the government must make. In 2012, debt ser-

vice—the amount the government must pay to cover the interest on the federal debt—was \$220 billion, or more than the federal government spent on agriculture, education, energy and transportation, combined.



WHAT'S THE TAKEAWAY?

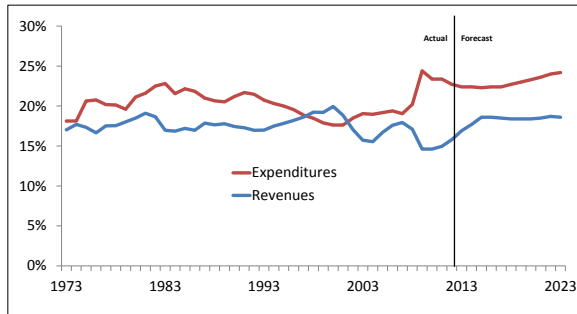
The national debt is a large and growing problem. Recent budget accords have not solved the debt crisis.

Low interest rates worldwide have held the interest burden of the U.S. debt artificially low. Those days are over.

In 2012, interest payments represented 6% of federal government outlays; in 2042 they are projected to be more than 30%.

Congress must stop the vicious circle of debt and debt service.

Figure 1: Total U.S. Federal Government Revenues and Expenditures, as a Percent of GDP

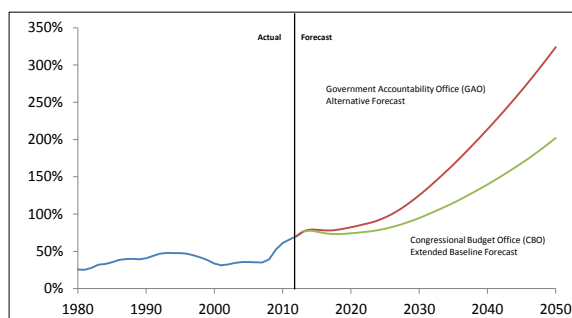


Sources: U.S. Congressional Budget Office and U.S. Government Accountability Office (Spring 2013).
 Note: The forecast comes from GAO's alternative simulation, which is based on the Trustees' assumptions for Social Security and the CMS Actuary's alternative assumptions for Medicare.

The typical American consumer can keep rolling over his credit card debts and sustaining his standard of living as long as a rising income covers his rising costs (and the bank doesn't get too nervous about the size of his outstanding balance). But if your spending is growing faster than your income and you're only making minimum payments, you will soon receive a notice from VISA or MasterCard that your credit limit has been hit and cannot be increased.

The U.S. is rapidly approaching the day when it too will receive such a notice. As shown in Figure 2, the national debt as a percentage of GDP stands at 73% in 2012,

Figure 2: The National Debt as a Percent of GDP



Source: U.S. Congressional Budget Office and U.S. Government Accountability Office (Spring 2013).
 Note: The GAO's alternative simulation is based on the Trustees' assumptions for Social Security and the CMS Actuary's alternative assumptions for Medicare. The CBO baseline forecast was extended by the GAO.

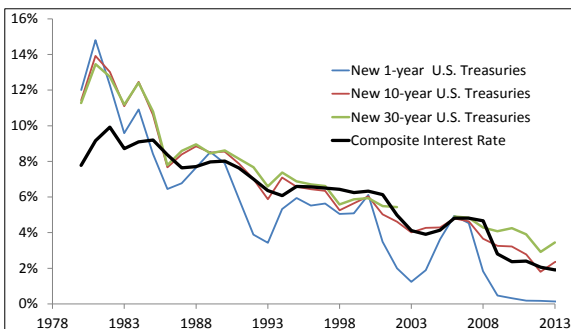
and according to projections from the U.S. Government Accountability Office (GAO), could rise to more than 100% by 2026. Unless dramatic policy changes are taken, it will not be VISA or MasterCard issuing a nasty letter. Instead it will be international currency markets telling us that dollar-denominated debt is no longer considered a safe investment. International credit markets will demand ever rising interest rates in exchange for holding our debt, and the U.S. will have no option but to pay it.

In 2012, the interest on the federal debt was \$220 billion, or more than the federal government spent on agriculture, education, energy and transportation, combined.

THE ROLE OF INTEREST RATES

Over the last few years, the weak worldwide economy has allowed the Federal Reserve to pursue a policy designed to drive down long term interest rates by buying longer term U.S. treasury debt and refinancing it with

Figure 3: The Interest Rate on Federal Debt



Sources: Federal Reserve Board, U.S. Congressional Budget Office and author's calculations.
 Note: 30-year U.S. Treasuries were not issued in 2003, 2004 or 2005. The composite interest rate is a weighted average of the interest rate paid on new and existing debt.

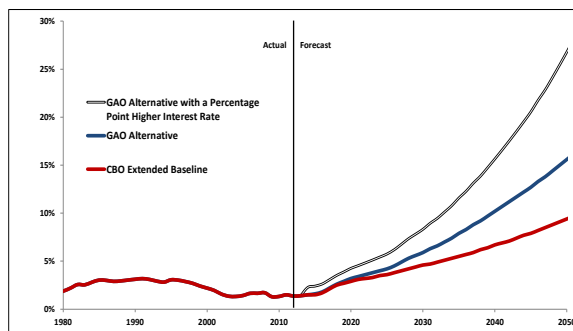
very short term debt at low interest rates. As a result, the interest rate the federal government paid on its debt in 2012 was less than half the interest rate it paid in 2008 and less than one-third of the interest rate it paid in 1998 (Figure 3).

With low worldwide rates on short term debt, the interest burden of the U.S. debt has been held artificially low. Those days are over. As the Federal Reserve winds down its stimulus efforts, interest rates will undoubtedly rise back toward historical norms.

When the debt is large, even modest increases in interest rates could lead to disastrous increases in the cost of debt service.

Rising interest rates mean a larger deficit and an even larger debt. Figure 4 shows how debt service expenditures would be impacted by rising interest rates and a rising debt. The red line shows the cost of debt service under what many consider the best case scenario (the Congressional Budget Office baseline, as extended by the GAO). The blue line shows the cost of debt service under the GAO's alternative simulation, which unlike the CBO baseline uses cost

Figure 4: Debt Service as a Percent of GDP under Alternative Scenarios



Source: U.S. Congressional Budget Office, U.S. Government Accountability Office (Spring 2013) and author's calculations.
 Note: The GAO's alternative simulation is based on the Trustees' assumptions for Social Security and the CMS Actuary's alternative assumptions for Medicare. The CBO baseline forecast was extended by the GAO.

projections generated by the agencies most directly involved (the Trustees' projections for Social Security and the Centers for Medicare & Medicaid Services Office of the Actuary's projections for Medicare.)

Both the CBO and the GAO projections assume that the interest rate on federal debt will rise sharply over the next few years, but never exceed 5%. The black line shows how the cost of debt service would rise under the GAO's alternative simulation if interest rates were one percentage point higher than originally assumed each year. As the figure clearly demonstrates, when the debt is large, even modest increases in interest

rates (as could easily happen if the world begins to doubt the credit worthiness of the United States) could lead to disastrous increases in the cost of debt service.

THE DEBT SERVICE BURDEN

All available evidence suggests that debt service will grab a bigger and bigger portion of GDP just to finance our past profligacy. It will also grab an increasing share of federal government expenditures. In 2012, debt service was 6% of total expenditures by the federal government; according to the GAO alternative simulation, by 2042, debt service will comprise more than 30% of federal government expenditures. Such a large debt service burden is unsustainable.

The larger is the deficit spending, the larger the debt, and the larger the debt, the higher the interest costs which in turn only increases deficit spending. It is a vicious circle that

policy makers must have the courage to address.

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ABOUT THE MOSBACHER INSTITUTE

The Mosbacher Institute was founded in 2009 to honor Robert A. Mosbacher, Secretary of Commerce from 1989-1992 and key architect of the North American Free Trade Agreement. Through our three core programs – Integration of Global Markets, Energy in a Global Economy, and Governance and Public Goods – our objective is to advance the design of policies for tomorrow's challenges.

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