WINTHROP WEALTH

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CLIENT QUESTION
OF THE MONTH

FEDERAL DEBT

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The federal debt has become a hot button issue over the last few years as the government has significantly increased its borrowing to combat the effects of the pandemic. The amount of federal debt held by the public now stands at over $23.9 trillion after increasing by 39% since 2019 and doubling over the last ten years. In our Client Question of the Month, we thought it would be helpful to revisit some of the most common questions associated with the federal debt.

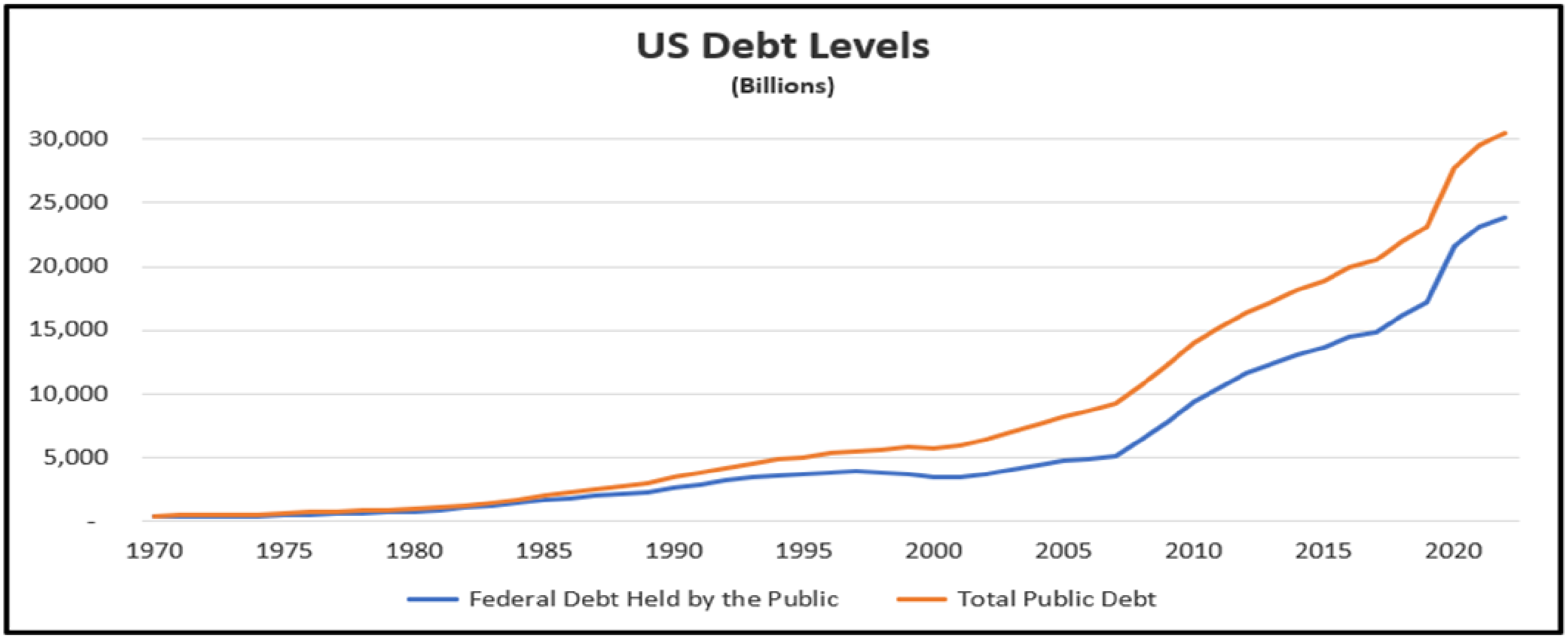
What is the Federal Debt?

The federal debt is simply the amount of money that the United States federal government has previously borrowed and subsequently owes. When the government borrows money, the Treasury Department sells securities to investors in the form of bills, notes, and bonds. Treasury securities ("Treasuries") are backed by the full faith and credit of the United States, which means their principal and interest payments are effectively assured by the government. Treasuries are offered in a wide range of maturities, are exempt from state and local taxes, and are usually very liquid.

The two basic measures of federal debt are debt held by the public and total public debt:

Federal Debt Held by the Public: the most common measure of federal debt and includes debt held by individuals, institutional investors, the Federal Reserve, state and local governments, and international investors. As of July 31, 2022, the total amount of US debt held by the public was $23.9 trillion.

Total Public Debt: is the federal debt held by the public plus debt held by federal trust funds and other government accounts. Social security comprises the largest percentage of debt held by federal trust funds and other government programs. As of July 31, 2022, the total amount of US gross debt was $30.6 trillion.



Source: Federal Reserve Bank of St. Louis

What drives the Federal Debt level?

The growth of federal debt is driven primarily by the government budget deficit. When spending exceeds revenue, the government is running a deficit. When the government incurs a budget deficit, the Treasury sells securities and uses the proceeds to fill the gap between revenue and expenses. Essentially the federal debt is the total accumulation of historical deficits. Typically, government deficits and debt have increased during periods of economic weakness and declined during expansions.

The budget deficit reached record levels of $3.1 and $2.8 trillion in 2020 and 2021 respectively due to the massive amount of fiscal stimulus. The **Congressional Budget Office (CBO)** currently estimates the deficit will remain around $1 trillion over the next several years. The deficit in future years will vary based on the government's priorities.

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022 Est	2023 Est	2023 Est
US Government Deficit	$1,294	$1,300	$1,077	$680	$485	$442	$585	$665	$779	$984	$3,129	$2,775	$1,036	$984	$1,056

Source: Congressional Budget Office (CBO)

What are the risks of too much debt?

The CBO describes that high and rising debt has two main consequences:

1. High debt levels decrease economic output over time. As debt levels increase, the government is forced to spend more of its budget on interest costs.
2. Higher interest costs would increase payments to international debt holders, and therefore reduce the income of US households.

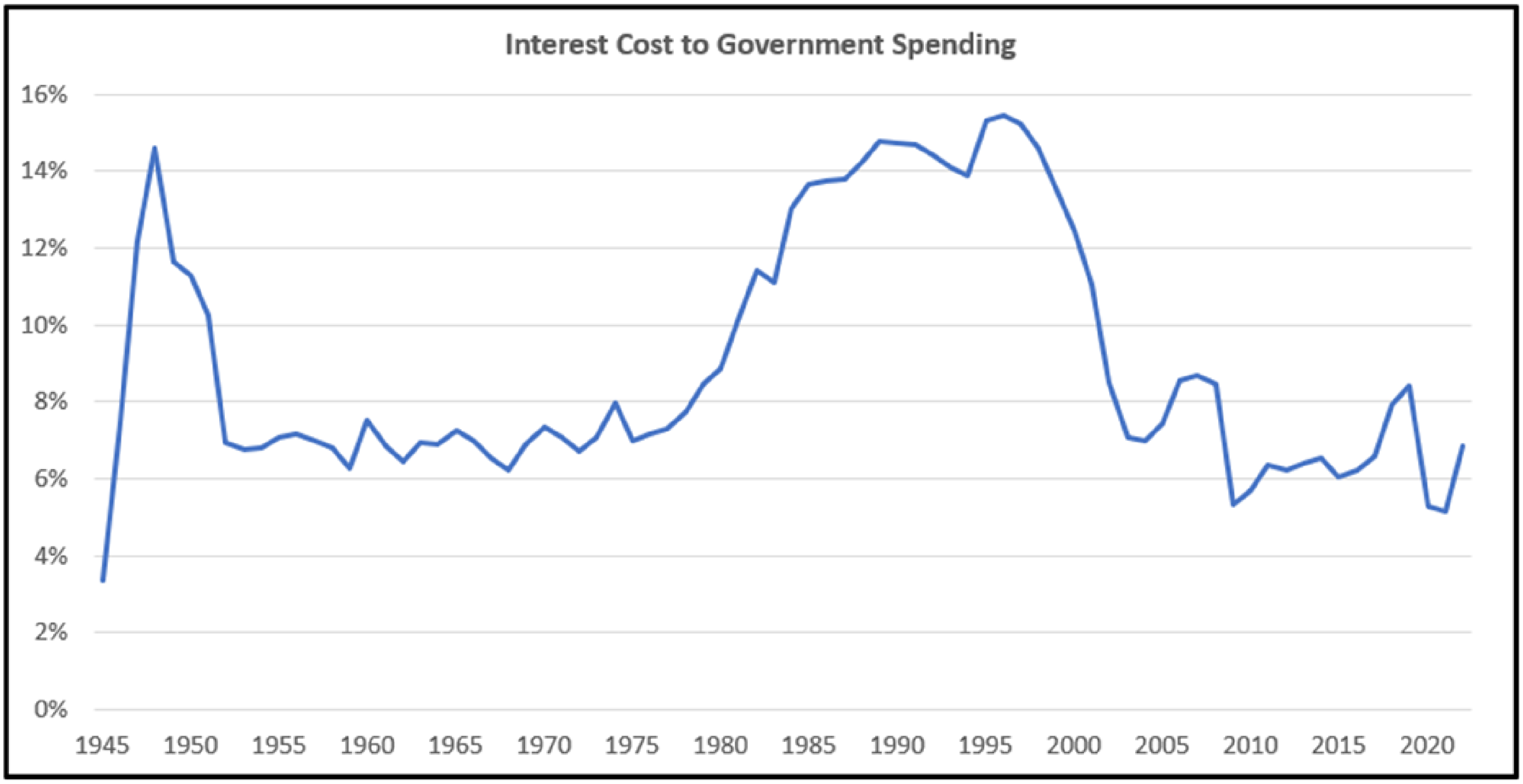
The CBO also cautions that rising debt levels elevate the risks of a financial crisis, high inflation, and eroding confidence in the dollar. Furthermore, high debt levels make the United States' fiscal position more vulnerable as policymakers may feel constrained from implementing deficit-financed programs during a crisis.

Does the debt need to be paid off?

The debt does not need to paid off in full, however the government does need to ensure that interest payments are sustainable. Rather than eliminating the debt, the government manages the debt by including interest costs as part of their overall spending.

The government's interest cost is defined as the payments on federal debt offset by the income received from various sources. The two primary factors that impact interest cost are the amount of debt outstanding and the interest rate on Treasury securities.The interest cost provides important context on how the government can service their debt payments.

In 2022, interest cost is estimated to be 6.8% of government spending.Since 1945 the historical average has been about 9.1%. While interest cost will be lower this year than the historical average, the measure has still risen from 5.3% in 2020 as both debt levels and interest rates have increased. We expect interest cost to government spending to continue to rise next year.



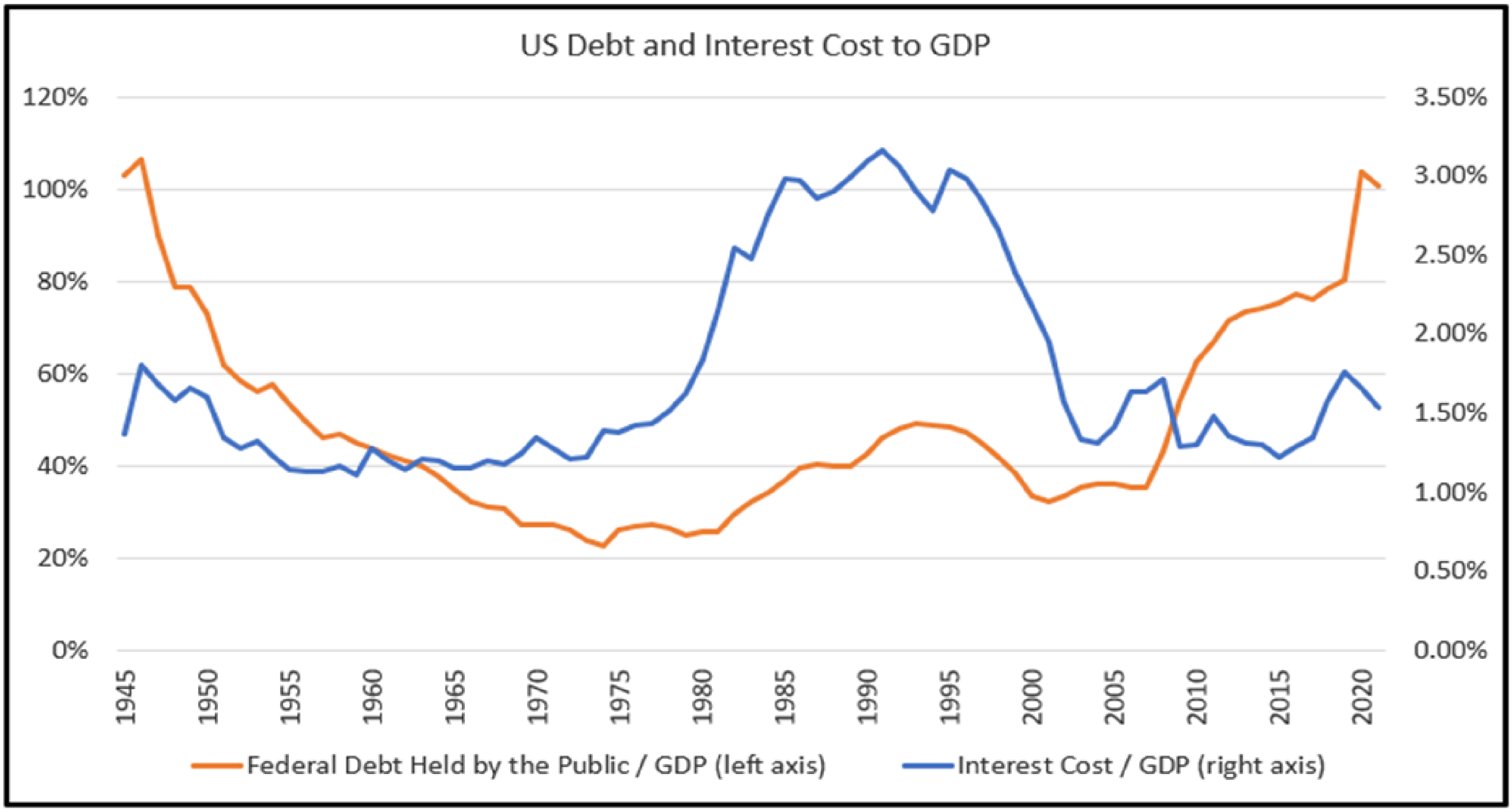
Source: Federal Reserve Bank of St. Louis

Can you put the debt level in context?

To compare amounts of debt in different years we thought it would be helpful to view both federal debt held by the public and interest cost in relation to the size of the economy (nominal GDP). The following chart shows the debt-to-GDP in orange and the interest cost-to-GDP in blue.

The debt-to-GDP ratio reached 106% in 1946 as the government borrowed heavily to finance defense spending during World War II. The ratio fell over the next several decades as the economy grew faster than the amount of outstanding debt. Since the Global Financial Crisis of 2008, debt levels have been rising significantly.The debt-to-GDP ratio ended 2021 at 101%. The CBO currently projects that debt-to-GDP will rise to 185% in 2052.

The interest cost-to-GDP ratio hit its peak level of 3.2% in 1991 and then declined along with interest rates. The ratio was 1.53% in 2021, slightly below to its historical average of 1.75%.The CBO projects this measure will rise to 7.2% in 2052.



Source: Federal Reserve Bank of St. Louis

What has the biggest impact on future deficit and federal debt levels?

The following four factors will have the biggest impact on the deficit and federal debt: government revenue (mainly tax policy), government spending, economic growth, and interest rates.

In a vacuum, each of the following events would increase/decrease the deficit and debt levels:

Increase Deficit and Federal Debt Level
- Lower Government Revenue
- Higher Government Spending
- Slower Economic Growth
- High Interest Rates

Decrease Deficit and Federal Debt Level
- Higher Government Revenue
- Lower Government Spending
- Faster Economic Growth
- Lover Interest Rates

How is Congress thinking about the deficit and debt?

Congress recently passed the Inflation Reduction Act, which includes approximately $740 billion in tax increases and $430 billion in new spending. The CBO estimates that the bill will reduce the deficit by approximately $300 billion over the next decade, including about $200 billion from increased IRS tax enforcement. On August 5th, President Biden stated, "I've made it a priority to bring down the federal deficit. The days of exploding federal deficits are over." While we are pleased the Biden Administration is working to cut the deficit, we would prefer a balanced budget so the debt level stops expanding. The CBO estimates that the budget deficit will be about $1 trillion in 2022 and will average about $1.5 trillion each year over the next decade. Unfortunately, we do not see any evidence that either Democrats or Republicans are pushing to balance the budget and decrease the federal debt.

Conclusion

The national debt is a very complicated issue with no clear answer on the level it becomes unsustainable or the best method to pay it down. Fed Chair Powell recently said that "debt is not at an unsustainable level, but the path is unsustainable, meaning it is growing faster than the economy. We have to address that over time." According to the CBO "no tipping point exists at which the debt-to-GDP ratio would become so high that it made a crisis likely or imminent; nor is there a fixed point at which interest costs would become so high in relation to GDP that they were unsustainable."

Government officials continue to follow a "kick the can down the road" strategy for the deficit and federal debt. Since the current debt level is not creating issues now, why bother addressing it? Our view is that Congress should begin to address the deficit and debt before long, as the country cannot count on a continued insatiable appetite for US Treasury securities and interest rates remaining low forever.

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