AUGUST 2023 CLIENT QUESTION OF THE MONTH

FEDERAL DEBT

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WINTHROP WEALTH

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 $25 trillion after increasing by 48% since 2019 and more-than-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.

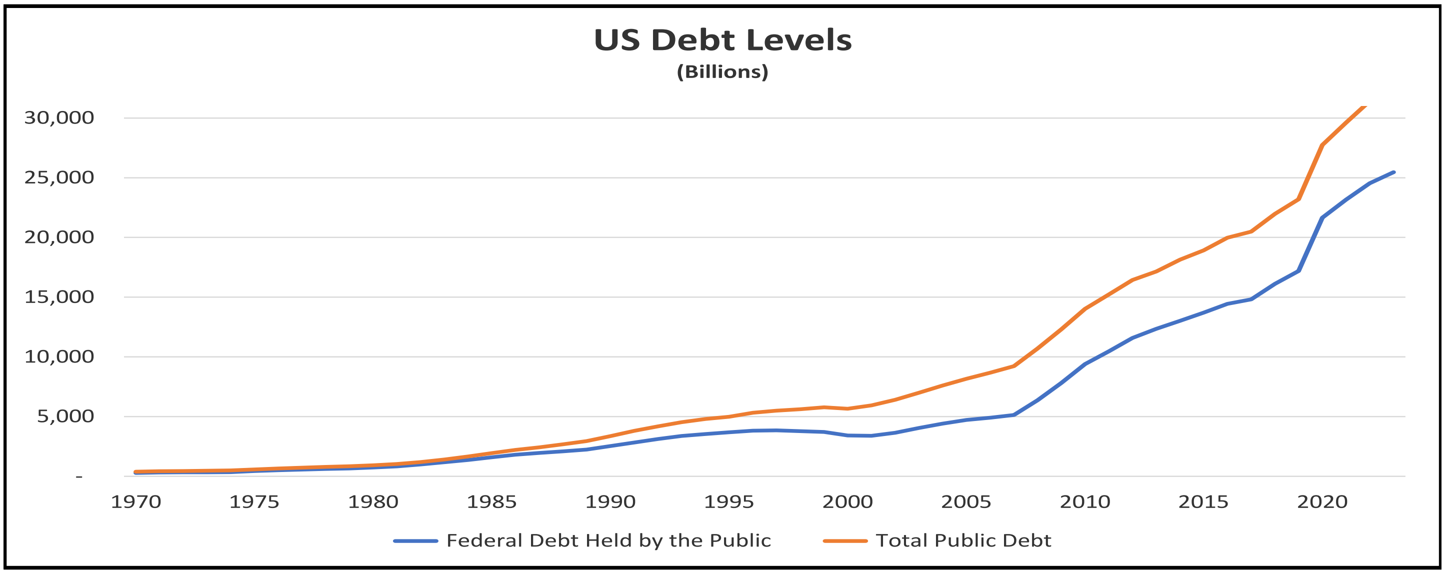
What is the Federal Debt?

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. *Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.*

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 June 30, 2023, the total amount of US debt held by the public was over $25 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 June 30, 2022, the total amount of US gross debt was above $32 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 -$1.6 trillion over the next several years. The deficit in future years will vary based on the government's priorities.

	2015	2016	2017	2018	2019	2020	2021	2022	2023 Est	2024 Est	2025 Est
US Government Deficit	-$442	-$585	-$665	-$779	-$984	-$3,132	-$2,775	-$1,376	-$1,539	-$1,571	-$1,761

Source: Congressional Budget Office (CBO)

What are the risks of too much debt?

The CBO describes that high and rising debt has several adverse consequences:

- 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 which crowds out discretionary spending that contributes to productivity and future growth.

- Higher interest costs would increase payments to international debt holders, and therefore reduce the income of US households.

- Rising debt levels elevate the risks of a financial crisis, high interest rates, high inflation, and eroding confidence in the dollar.

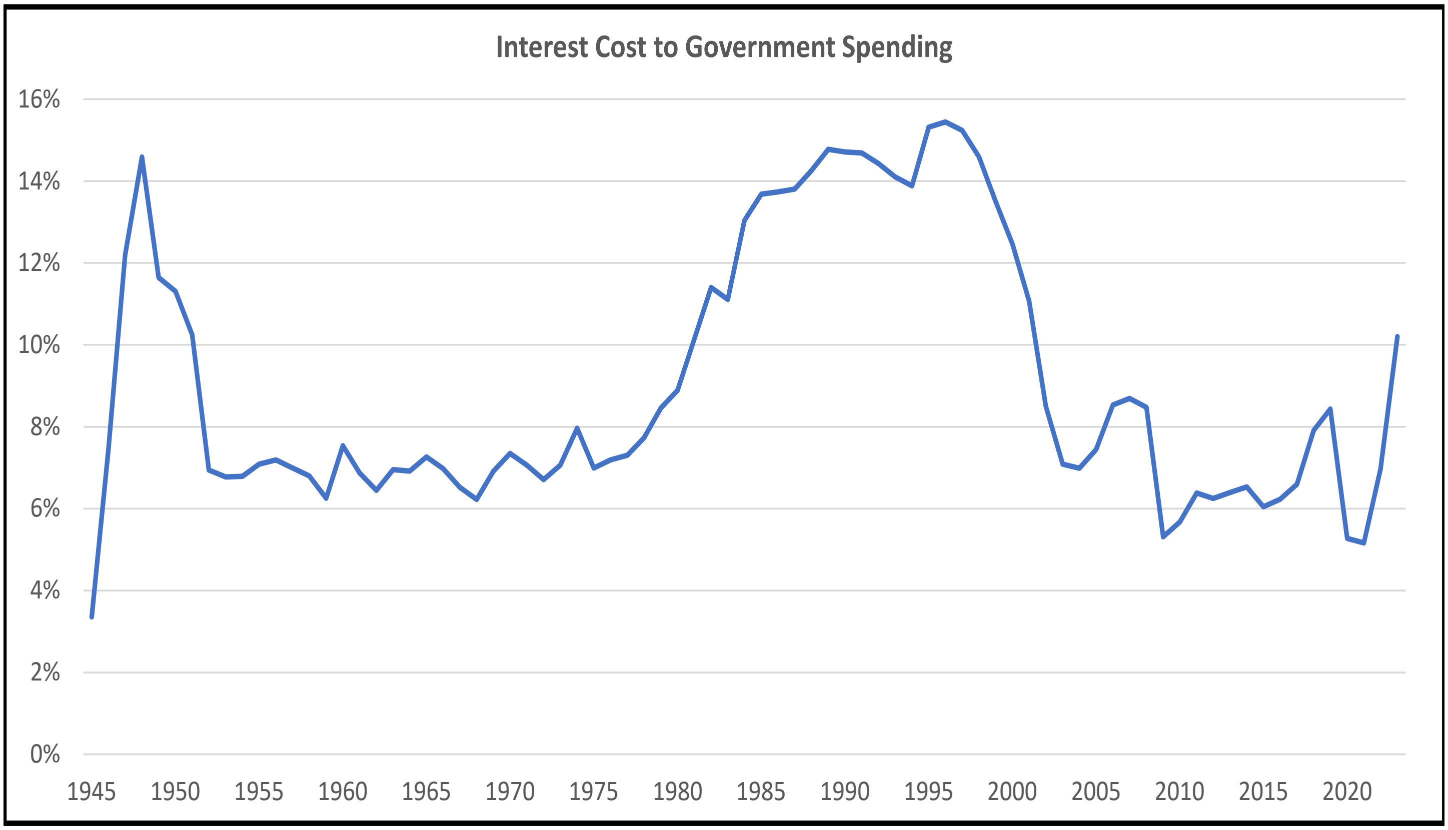
- Furthermore, high debt levels make the United States' fiscal position more vulnerable as policymakers may feel constrained from implementing deficit-financed programs during a crisis.

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 2023, interest cost is estimated to be 10.0% of government spending. Since 1945 the historical average has been about 9.1%. We expect interest cost to government spending to continue to rise next year.



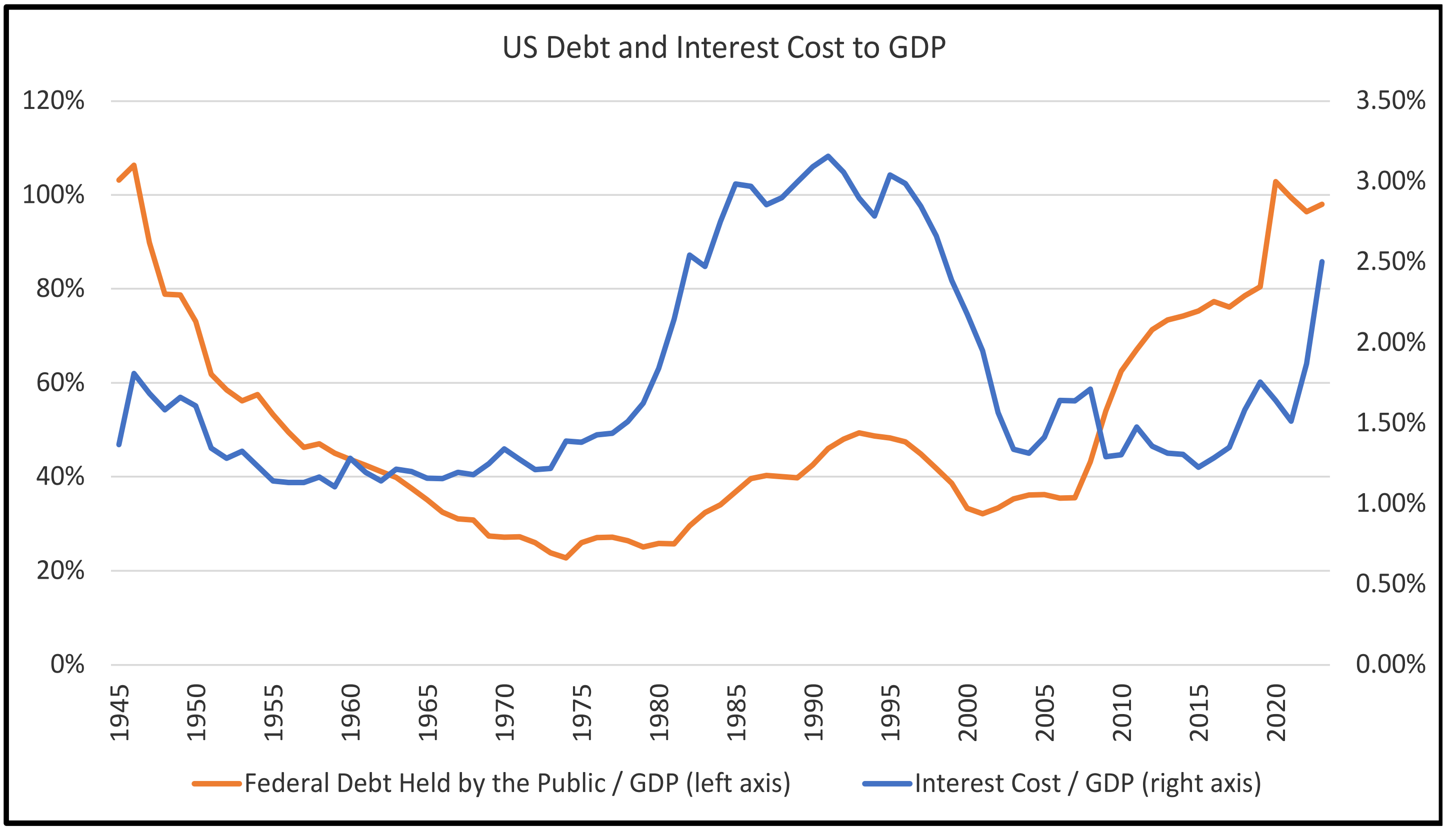
Source: Federal Reserve Bank of St. Louis

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 is estimated to reach 98% in 2023. The CBO currently projects that debt-to-GDP will rise to 181% in 2053.

The interest cost-to-GDP ratio hit its peak level of 3.2% in 1991 and then declined along with interest rates. The ratio is estimated to reach 2.50% in 2023, slightly above historical average of 1.76%. The CBO projects this measure will rise to 6.7% in 2053.



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 Federal Debt Level
- Lower Government Revenue
- Higher Goverment Spending
- Slower Economic Growth
- Higher Interest Rates

Decrease Federal Debt Level
- Higher Government Revenue
- Lower Goverment Spending
- Faster Economic Growth
- Lower Interest Rates

What is Congress doing about the deficit and debt?

The short answer is not much.

In early June, Congress passed the "Fiscal Responsibility Act of 2023" that raised the debt ceiling until January 2025 while keeping nonmilitary spending roughly flat for fiscal year 2024 and setting a 1% cap on spending increases for fiscal year 2025. The CBO estimates that the bill will reduce budget deficits by about $1.5 trillion total over the next 10 years from their prior baseline projections. According to the CBO, the projected budget deficit is still going to average -$1.6 trillion over the next three years. While introducing some spending restraint is positive, the government is still about a trillion-and-a half away from a balanced budget.

In March, the press release accompanying President Biden's proposed budget included the imaginative statement that the President "cut the deficit by more than $1.7 trillion during his first two years in office—the largest decline in American history." Where did the $1.7 trillion "cut" come from? The deficit was -$3.1 trillion in 2020 due to massive amounts of stimulus to combat the pandemic. In 2022, the deficit was -$1.4 trillion, or $1.7 trillion less than 2020's level. Still running a trillion-dollar-plus deficit two years removed from once-in-a-generation spending levels that were designed to keep the economy afloat during a global pandemic does not warrant a victory lap. Only a politician running for re-election could take credit for that type of accomplishment.

While it may appear that we are picking on the President and the Democratic party, we do not see much evidence that Republicans are focused on deficit and debt either. Earlier this year, House Speaker Kevin McCarthy stated his goal was to put the country on a path to a balanced budget within ten years. According to the nonpartisan Committee for a Responsible Federal Budget (CRFB), without raising taxes, all government spending would need to decrease by 25% to balance the budget within ten years. The reduction in government spending would need to be 85% if defense, veterans, Social Security, and Medicare were not included. In other words, the most likely way to balance the budget is through tax increases and/or entitlement spending cuts. And Republicans aren't calling for either right now. In our view, the goal of a balanced budget within a decade appears to be lip service as we have not seen a credible plan on how to arrive at that destination.

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 has repeatedly 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 can be identified 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 levels and deficits are not creating issues now, why bother addressing it? Especially since fixing the problem likely requires difficult decisions on taxes and/or entitlement spending.

Our view is that the trajectory of the federal debt is the top long-term issue facing the economy. We would welcome Congress starting to take material actions to address the deficit and debt before the tipping point is breached. We will continue to monitor while we hope that Washington wakes up to the issue.

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