WINTHROP WEALTH

AUGUST 2024 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 after the government significantly increased its borrowing during the pandemic and deficits have been maintained at historically high levels since. The amount of federal debt held by the public now stands at over $27 trillion after increasing by 60% 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.

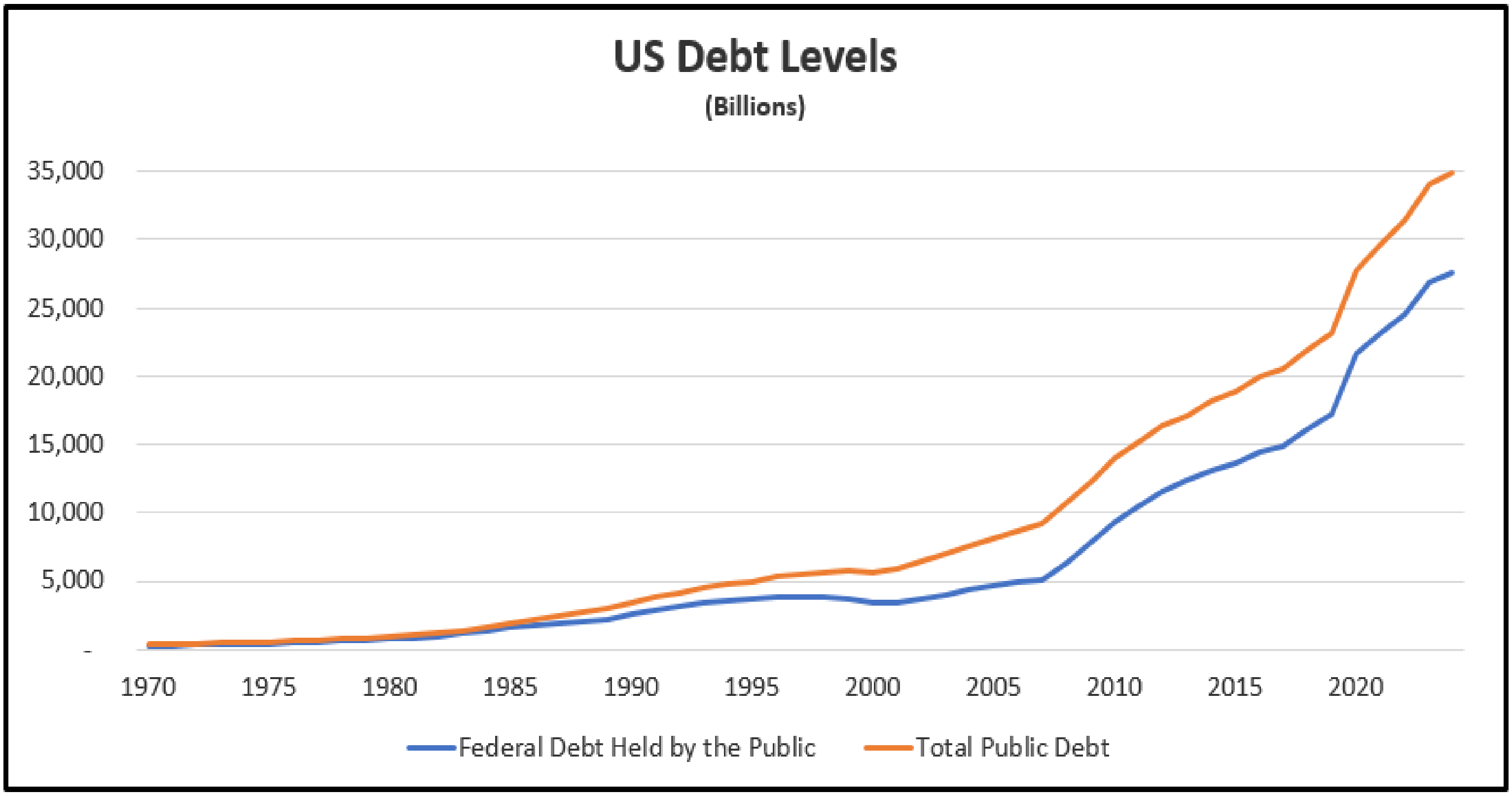
What is the Federal Debt?

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. *Treasuries 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: is 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, 2024, the total amount of US debt held by the public was over $27.6 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, 2024, the total amount of US gross debt was above $34.8 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 -$1.9 trillion over the next several years. The deficit in future years will vary based on the government's priorities.

	2016	2017	2018	2019	2020	2021	2022	2023	2024 Est	2025 Est	2026 Est
US Government Deficit	-$585	-$665	-$779	-$984	-$3,132	-$2,775	-$1,376	-$1,694	-$1,915	-$1,938	-$1,851

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:

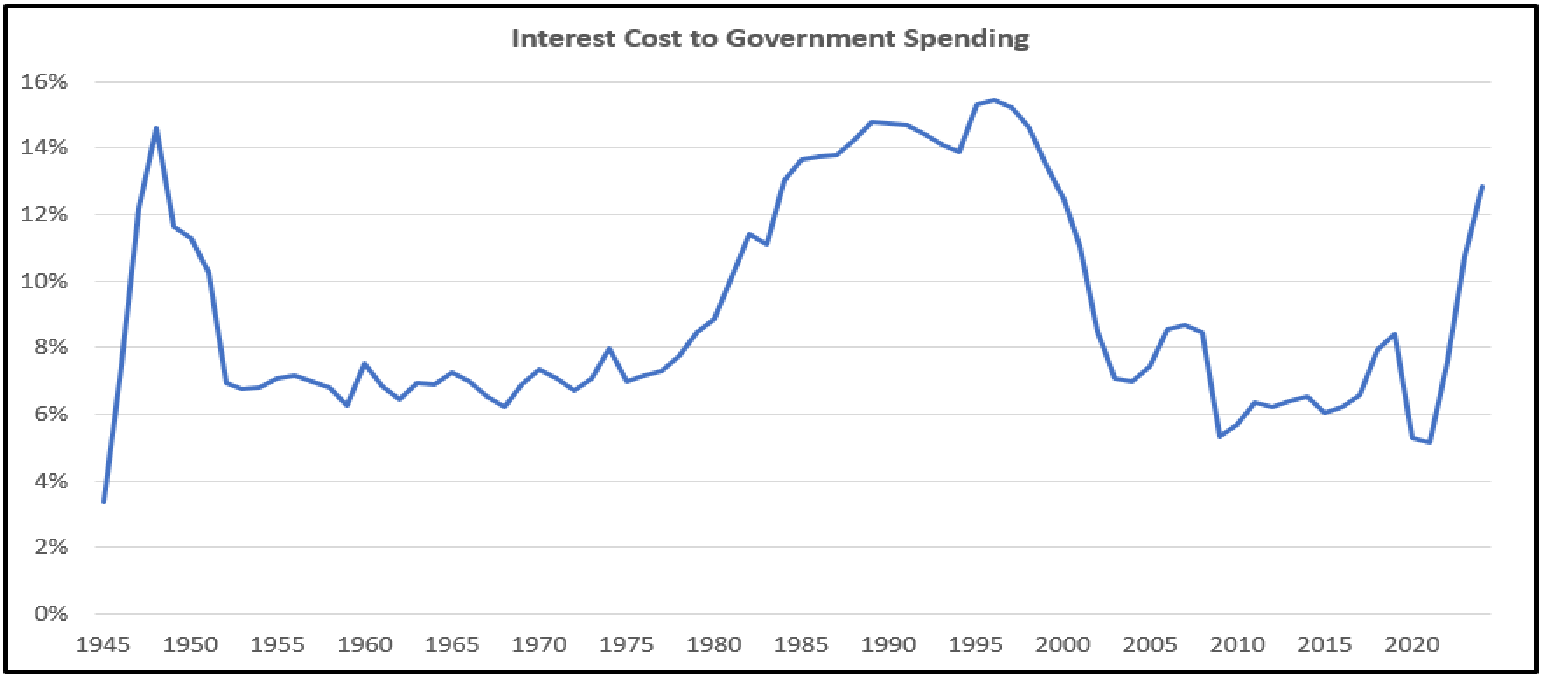
- High debt levels decrease economic output over time. As debt levels increase, the government is forced to spend more of its budget on interest costs which crowds out discretionary spending that contributes to productivity and future growth.
- Higher interest costs would increase payments to international 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 fiscal 2023, the government spent more on interest than Medicaid. Interest cost is on pace to exceed spending on Medicare and Defense as soon as 2024.

In 2024, interest cost is estimated to be 12.9% of government spending. Since 1945 the historical average has been about 9.1%. We expect interest cost to government spending to continue to rise for the foreseeable future.



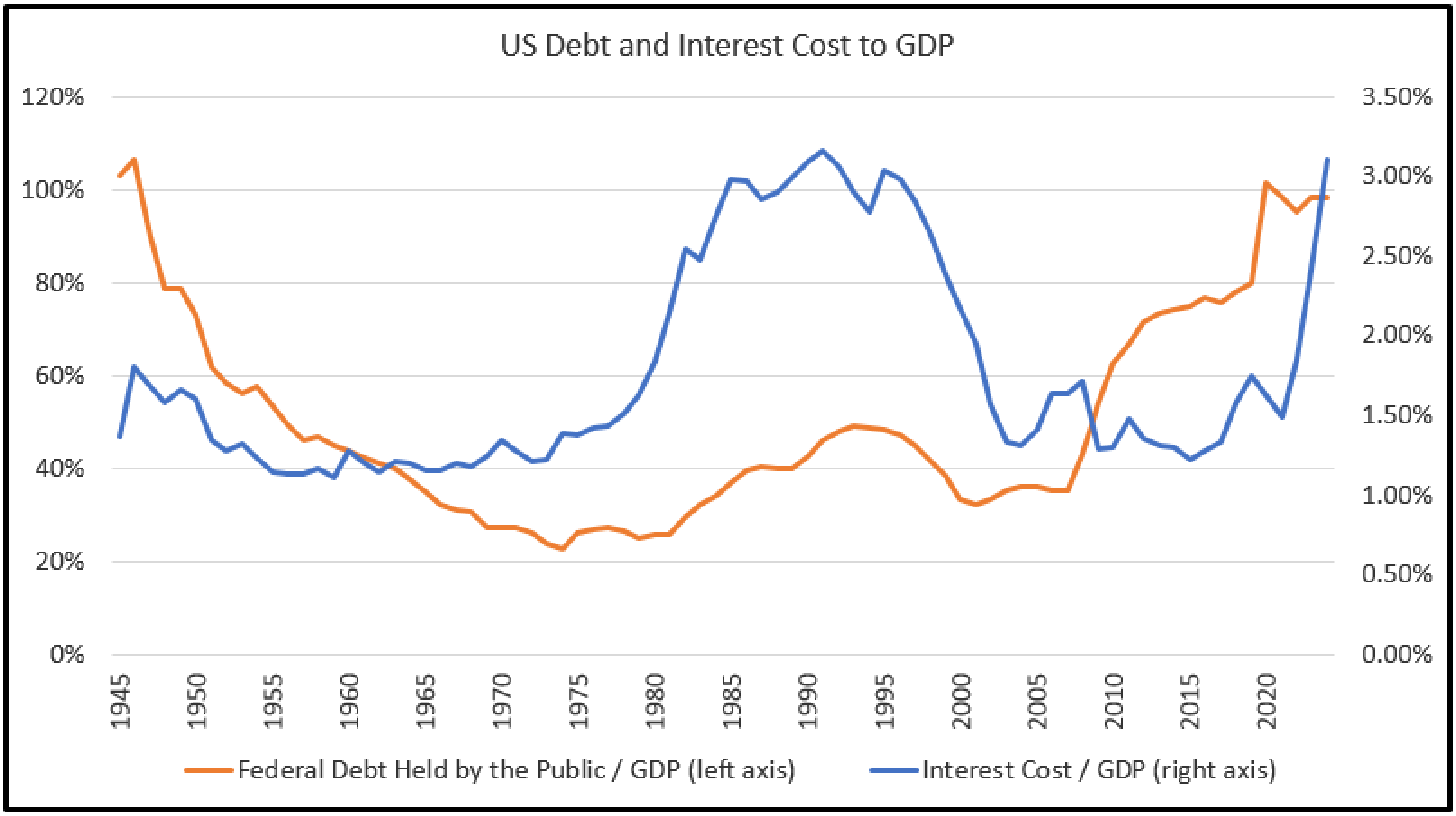
Source: Federal Reserve Bank of St. Louis

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 99% in 2024. The CBO currently projects that debt-to-GDP will rise to 122% in 2034.

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 3.1% in 2024, well-above the historical average of 1.8%. The CBO projects this measure will rise to 4.1% in 2034. The CBO also notes that interest cost-to-GDP is estimated to exceed the prior peak level of 3.2% in every year from 2025 to 2034.



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 Government Spending
Slower Economic Growth
Higher Interest Rates

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

Is the White House or Congress doing anything about the deficit and debt?

No. This is our fourth annual update to the Federal Debt Client Question. Over the last year, the deficit has expanded toward $2 trillion under a solid economy, overall debt levels continue to rise, and interest cost as a percentage of both government spending and GDP are close to record levels. Neither Democrats nor Republicans have put out a credible plan to address the snowballing debt.

Have the two Presidential Candidates released any plans to address the deficit and debt?

Not any credible ones.

President Biden released his proposed budget earlier this year which projects a $3 trillion reduction in the deficit over the next decade, compared to deficits without the new policies. In other words, the government would still run a cumulative total of about $16 trillion in deficits over the next ten years. The White House continues to gloat that, "compared to when the President took office, the deficit is over $1 trillion lower." Where was that "$1 trillion" cut? The deficit was -$3.1 trillion in 2020 due to massive amounts of stimulus to combat the pandemic. In 2024, the CBO projects a deficit of about $1.9 trillion or $1.2 trillion less than 2020's level. Still running a near two trillion-dollar deficit four years removed from once-in-a-generation spending levels is not something to gloat about.

Some of President Biden's budget proposals include a repeal of the 2017 tax cuts, raising the top marginal tax bracket from 37% to 39.6% for those making more than $400,000 per year, taxing capital gains at the same rate as income for those with income above $1 million, increasing the corporate tax rate from 21% to 28%, and instituting a 25% minimum tax on those with wealth greater than $100 million. Our view is that these proposals would likely have a difficult time passing Congress without a strong Democratic majority in both chambers.

Former President Trump does not seem to be too interested in releasing realistic plans to reduce the deficit and debt either. Under President Trump's watch the deficit expanded each year during his first three years in office before exploding to record levels during 2020's covid spending. At the June Debate, Former President Trump stated that if not for the pandemic, "we were ready to start paying down debt." That line is a great example of counterfactual thinking, but probably not a realistic scenario.

As of this writing, Former President Trump has not released any detailed economic or budget proposals for a potential second term. We do know a few key points, including Trump's desire to extend the 2017 Cuts and Jobs Act and to lower the corporate tax rate to 15%. Former President Trump also plans to use tariffs, which may help offset some of the cost of his tax cut proposals. We hope to see plans to lower the deficit and move toward a balanced budget, which would be required to pay down the debt, but we won't hold our breath.

Conclusion

The national debt is a very complicated issue with no clear answer on the level it becomes unsustainable. 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. A politician pushing to cut spending and/or increase taxes runs the risk of not getting elected. Let someone else worry about that.

The debt and deficit dilemma probably goes unattended until something breaks, likely through additional credit downgrades or an increase in interest rates if buyers of Treasury securities go on strike. 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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Citations

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