WINTHROP WEALTH

AUGUST 2025 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 almost $29 trillion after increasing by nearly 70% 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.

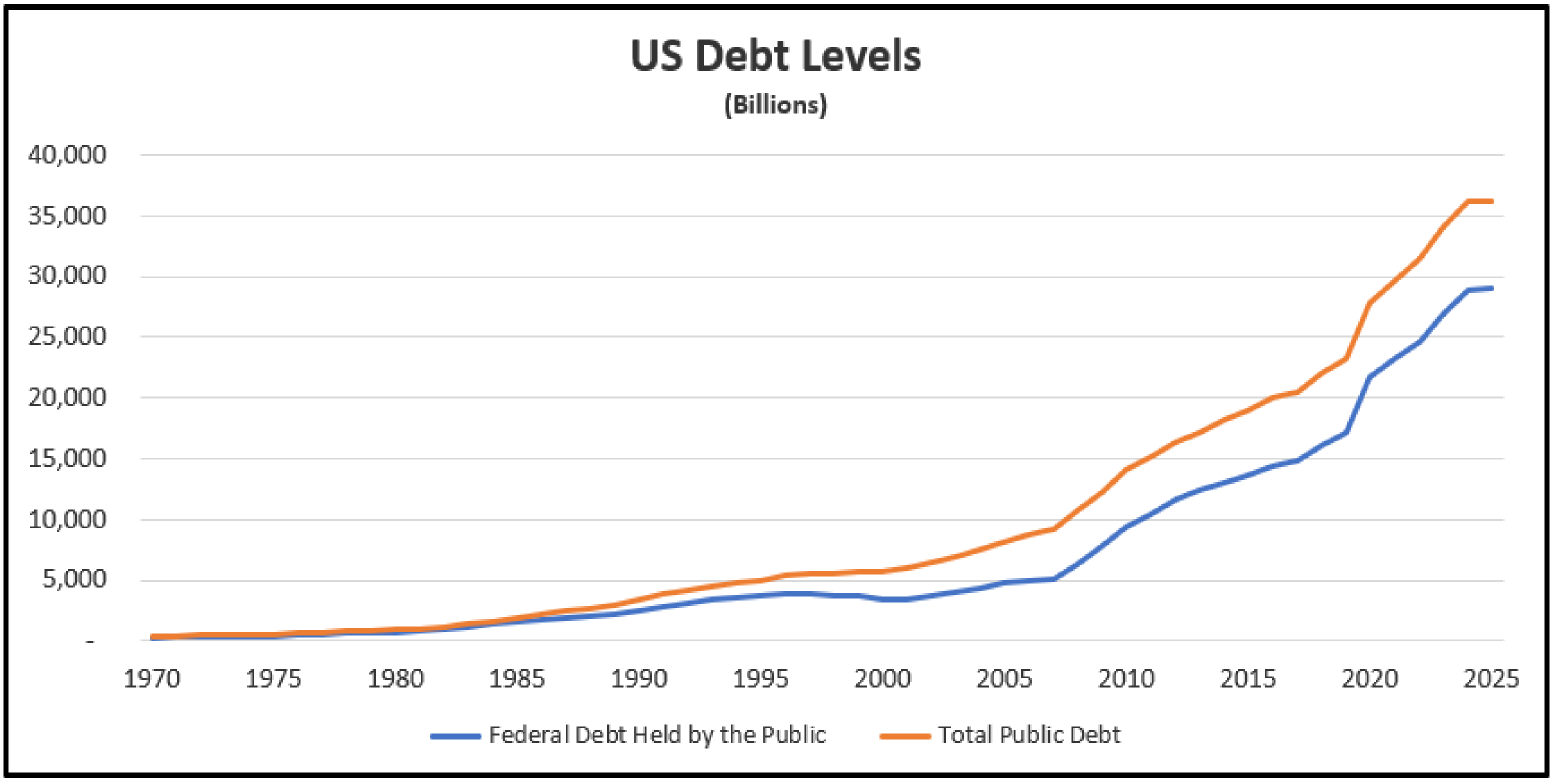
What is the Federal Debt?

The federal debt is the total amount of money that the United States federal government has borrowed and not yet repaid. When the government runs a budget deficit, it finances the shortfall by issuing Treasury securities — including bills, notes, and bonds — through the US Department of the Treasury. These securities are purchased by a range of investors, including individuals, institutions, foreign governments, and other parts of the federal government. Treasury securities ("Treasuries") are backed by the full faith and credit of the United States, meaning their principal and interest payments are effectively assured by the government. Treasuries are issued in a wide range of maturities, are exempt from state and local income taxes, and are typically 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 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 used 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, 2025, the total amount of US debt held by the public was over $28.9 trillion.

Total Public Debt: is the sum of debt held by the public plus debt held by federal trust funds and other government accounts. The Social Security Trust Fund comprises the largest portion of the debt held by the latter. As of June 30, 2025, the total amount of US gross federal debt was above $36.2 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 federal spending exceeds revenue, the government runs a deficit. To finance this gap, the US Treasury issues securities and uses the proceeds to fund operations. 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 federal budget deficit reached record levels of $3.1 trillion in 2020 and $2.8 trillion in 2021, largely due to the massive fiscal response to the COVID-19 pandemic. The Congressional Budget Office (CBO), as of its January 2025 baseline, projects annual deficits of approximately $1.8 trillion over the next several years. These projections are based on current law and do not incorporate the potential impact of recently enacted policies, including the One Big Beautiful Bill Act (OBBA) and newly imposed tariffs, both of which are expected to materially influence future deficit levels.

	2016	2017	2018	2020	2021	2022	2023	2024	2025 Est	2026 Est	2027 Est
US Government Deficit	-$665	-$779	-$984	-$3,132	-$2,775	-$1,376	-$1,694	-$1,832	-$1,865	-$1,713	-$1,687

Source: Congressional Budget Office (CBO). Figures in billions of dollars.

What are the risks of too much debt?

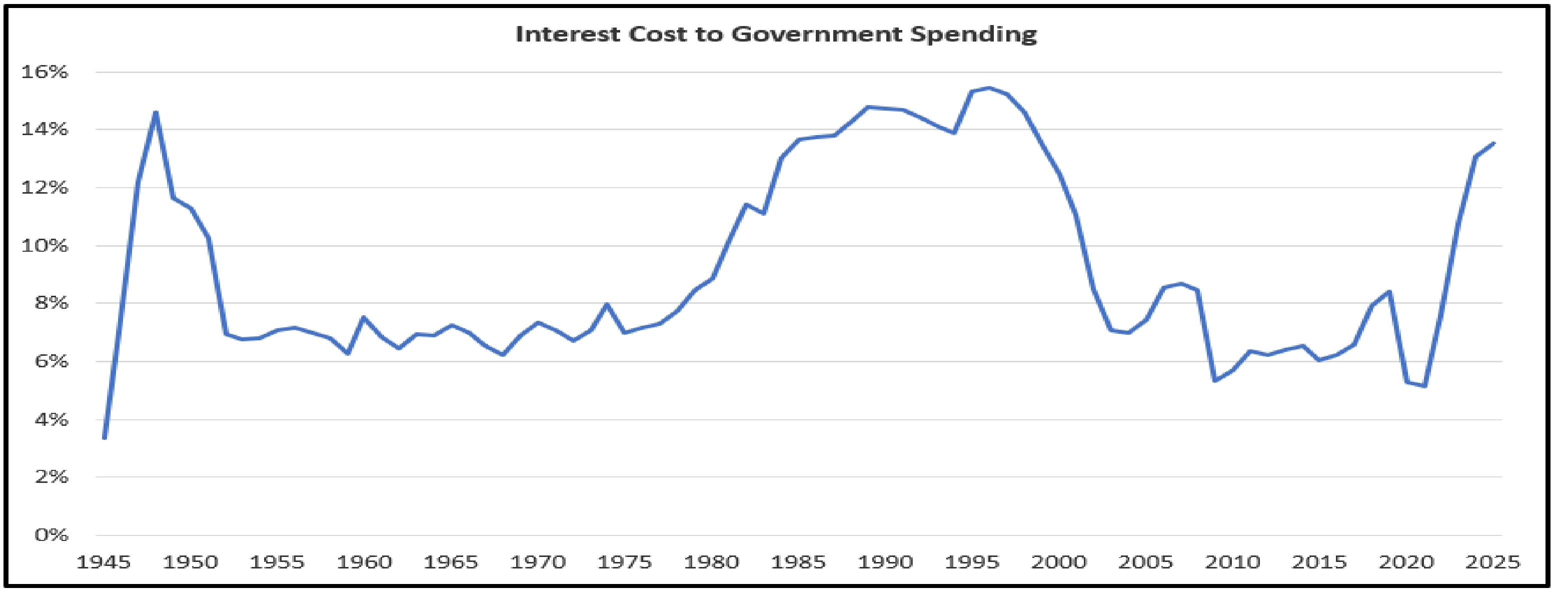
The CBO describes that high and rising federal debt can have several adverse long-term consequences:

- Slower Economic Growth: As debt rises, the government must devote a larger share of its budget to interest payments, which can crowd out discretionary spending on areas that support future productivity and growth.
- Reduced National Income: Higher interest payments on federal debt - especially those paid to foreign holders - divert income away from US households and the domestic economy.
- Heightened Risk of Financial Instability: Rising debt levels elevate the risks of a fiscal crisis, surging interest rates, persistent inflation, or a loss of confidence in the dollar and US creditworthiness.
- Less Fiscal Flexibility: High debt may limit policymakers' ability to respond to future recessions or emergencies with deficit-financed stimulus, making the US economy more vulnerable during crises.

Does the debt need to be paid off?

The federal debt does not need to be paid off in full, but interest payments must remain sustainable. Rather than eliminating the debt, the government manages it by budgeting for net interest—defined as total interest paid on federal debt, offset by interest income from federal accounts.

Net interest costs are driven by two factors: the amount of debt outstanding and prevailing interest rates. In fiscal year 2024, interest payments totaled an estimated $881 billion, exceeding spending on Defense ($850 billion), Medicare ($865 billion), and Medicaid ($618 billion). In 2025, interest is projected to account for 13.6% of total federal spending, well above the historical average of 9.2%. That share is expected to continue rising as both debt levels and rates remain elevated.



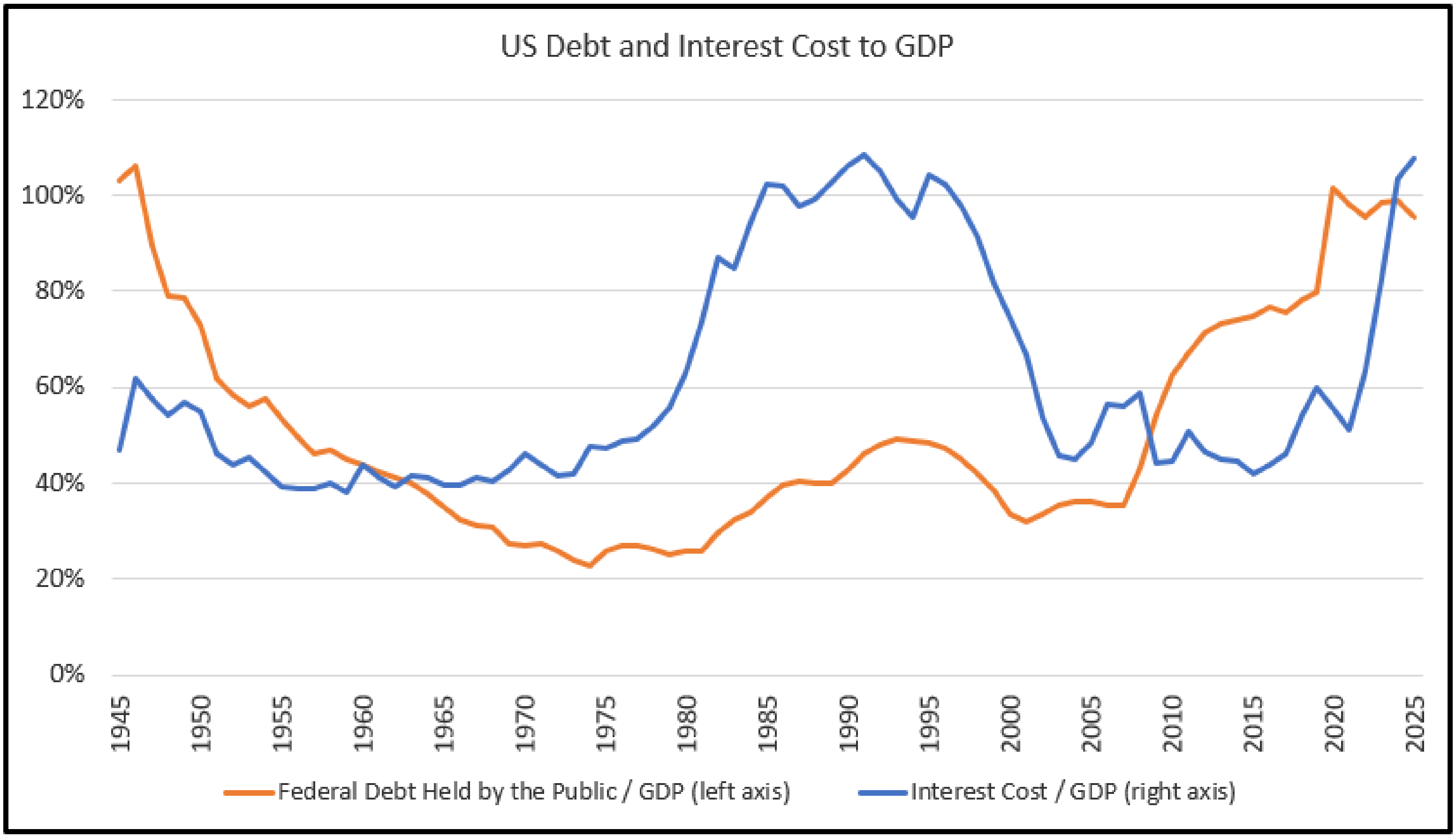
Source: Federal Reserve Bank of St. Louis

Can you put the debt level in context?

To provide meaningful context for today's debt levels, we've plotted federal debt held by the public and net interest costs as a percentage of GDP. Debt-to-GDP is shown in orange and interest-cost-to-GDP in blue.

After peaking at 106% in 1946 due to World War II borrowing, the debt-to-GDP ratio declined for decades as economic growth outpaced borrowing. Since the 2008 financial crisis, debt has climbed significantly. It is estimated to reach 100% in 2025, with the CBO projecting a rise to 117% by 2034.

Net interest cost in relation to GDP hit a high of 3.2% in 1991, then fell alongside interest rates. That ratio is expected to return to 3.2% in 2025, well above its long-term average of 1.8%, and could climb to 4.0% of GDP by 2034. The CBO also notes that interest costs will exceed their historical peak every year from 2025 through 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

How Will OBBA and Tariffs Affect the Fiscal Outlook?

As of its January 2025 baseline, the Congressional Budget Office (CBO) projects average annual federal deficits of roughly $2.0 trillion over the next decade. These projections do not account for the One Big Beautiful Bill Act (OBBA) or recently announced tariffs, both of which are expected to significantly influence the fiscal outlook.

In a June 2025 cost estimate, the CBO projected that OBBA would increase the primary deficit by $2.4 trillion between 2025 and 2034. When including an estimated $551 billion in additional interest costs, the total impact on the deficit rises to nearly $3.0 trillion over the 10-year period.

In a separate analysis, the CBO estimated that recently enacted tariffs could generate approximately $2.8 trillion in additional customs revenue over the same timeframe. Tariffs reduce the budget deficit by increasing federal revenue - customs duties are transferred to the US Treasury and treated as general receipts. However, the CBO also estimates that changes in tariffs will reduce the size of the US economy, partly because other countries will retaliate.

As a result, actual deficit outcomes may vary meaningfully from current projections, depending on how these policies are implemented and how the broader economic environment evolves. While tariff revenue may offset OBBA's cost on paper, the true deficit impact will depend on policy effectiveness and evolving economic conditions.

Conclusion

The US federal government is on an unsustainable fiscal path. And that just means that the debt is growing faster than the economy. I don't think that's at all controversial. And I think we know that we have to get back on a sustainable fiscal path. It's probably time, or past time, to get back to an adult conversation among elected officials about getting the federal government back on a sustainable fiscal path.

- Fed Chair Jerome Powell (February 2024)

The national debt is a very complicated issue with no clear answer on when it becomes unsustainable. 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."

This marks our sixth annual update to the Federal Debt Client Question. Following the pandemic, deficits remained elevated despite a solid economy, while overall debt levels continued to rise and interest costs, measured as a share of both government spending and GDP, approached record highs. Both Democrats and Republicans share responsibility, as each party has supported major spending initiatives without offsetting them with new revenues. The constant is that the party in power spends freely, while the minority party suddenly pretends to care about balancing the budget.

Government officials continue to take a "kick the can down the road" approach to the deficit and federal debt. Since current debt levels and deficits aren't causing immediate problems, there's little political incentive to act — especially when real solutions likely involve tough choices on taxes or entitlement spending. After all, a politician advocating spending cuts or tax increases risks not getting elected. Better to let someone else deal with it later.

The debt and deficit dilemma probably goes unattended until something breaks, likely through additional credit downgrades or a spike in interest rates if buyers of Treasury securities go on strike. Our view is that the trajectory of the federal debt is the most important long-term issue facing the economy. We would welcome meaningful action from Congress to address the deficit and debt before a tipping point is reached. We will continue to monitor while we hope that Washington wakes up to the issue.

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Citations

The Budget and Economic Outlook: 2025 to 2035. Congressional Budget Office. https://www.cbo.gov/publication/60870

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Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.