

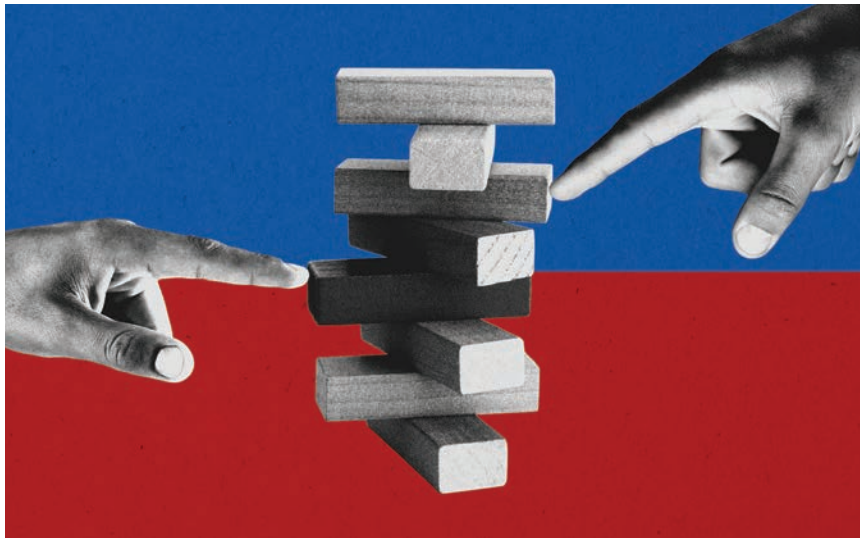
Point of View

America's Perilous Fiscal Path

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It's easier to explain how the US got into its fiscal difficulties than how it will get out of them



In 1990, US public debt stood at 43 percent of gross national product (GNP). The economy was growing only slowly, the unemployment rate exceeded 5 percent, and the Congressional Budget Office forecast that deficits would fall over the following five years, from 4.0 percent to 1.8 percent of GNP.

And yet President George H.W. Bush was so concerned about mounting national debt that he hammered out a deal with a Democratic-controlled Congress to shore up public finances. The president had campaigned on a promise to impose no new taxes, so the agreement, which comprised tax increases and spending cuts projected to save nearly \$500 billion over five years, posed a clear political risk. Voters threw him out of office two years later.

In July 2025, with US debt approaching 100 percent of gross domestic product (now the preferred measure of the economy's overall size and only slightly smaller than GNP), unemployment just over 4 percent, and deficits pro-

jected to rise from 5.5 percent to 5.9 percent of GDP by 2030, President Donald J. Trump and a Republican-controlled Congress pushed through the One Big Beautiful Bill Act, at a cost of about \$2 trillion over the next five years.

The contrast between these two episodes, 35 years apart, spotlights a remarkable shift in US attitudes toward national debt. The world's largest economy is in a precarious fiscal position, with a debt-GDP ratio poised to breach its historic post-World War II high. But unlike in 1946, there is no large peace dividend from reduced defense spending to rescue public finances. Demographic factors are pushing spending even higher through the continuing expansion of old-age entitlements, and there seems little prospect of avoiding large deficits and higher debt, even if economic conditions remain favorable.

Major economic shocks

How did we get here? First, national debt has increased sharply because of two major economic shocks, the global financial crisis and the COVID-19 pandemic. Revenues went down and spending went up automatically as the economy weakened and government sought to offset declining incomes with large fiscal stimulus packages. Two very large shocks in little more than a decade are highly unusual. It's almost a century since the US last experienced a shock as large as the global financial crisis, during the Great Depression. But the US government then was a fraction of its current size, and its capacity to incur debt was much smaller.

A second explanation for the perilous US fiscal position is political polarization. Cutting deficits does not provide tangible short-term benefits. Politicians do not become popular by asking voters to pay higher taxes or put up with reduced transfer payments or government services. As in 1990, the key to fiscal consolidation is bipartisan agreement: Neither party can then blame the other for short-term outcomes voters may not like. Indeed,

this was the philosophy behind the 2010 establishment of the National Commission on Fiscal Responsibility and Reform, more commonly known as the Simpson-Bowles Commission, cochaired by a Republican and a Democrat.

With the parties now further apart, it's more difficult for them to come to an agreement. The tax increases that Democrats want are unacceptable to Republicans, and Democrats are just as opposed to the spending cuts that Republicans want. Even though the fiscal picture is much worse than in 2010, when policymakers ultimately ignored the Simpson-Bowles Commission's recommendations, today there is no prospect of another bipartisan attempt to solve the fiscal problem.

No observable damage

Another explanation for the loss of concern about deficits is the lack of observable damage. Policymakers traditionally make the case to voters for fiscal consolidation by arguing that higher national debt raises interest rates. This imposes a heavier debt-service burden on the government itself but also raises costs for households when they borrow to buy a home or a car. Empirical evidence confirms that higher national debt does indeed increase interest rates, but other factors have until very recently pushed interest rates steadily lower, continually defying predictions.

In the two decades from 2001 to 2021, as the US debt-GDP ratio more than tripled, debt service actually fell as a share of GDP, from 2.0 percent to 1.5 percent. The decline in interest rates was so pronounced that it more than offset the huge debt increase. Today politicians rarely warn of the effects of debt on interest rates—just as debt service has begun growing sharply again. And even without higher interest rates, the sharp rise in debt has already caused economic damage, notably by increasing the US external imbalance and potentially crowding out productive domestic private investment. But these costs are more subtle and harder to communicate.

Unfortunately, it's easier to explain how we got into the present fiscal situation than how we will get out of it. Some

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project that the US debt-GDP ratio will nearly double in size over the next three decades. This may compromise access to capital markets—even for a traditional safe haven economy. Before then, the ability of the government to incur massive debt over a short period of time, as it did during the global financial crisis and the COVID pandemic, is questionable. We don't know if we will still have the fiscal space to act forcefully.

Distinct fiscal futures

In Ernest Hemingway's novel *The Sun Also Rises*, a character is asked how he went bankrupt. “Two ways,” he answers. “Gradually, then suddenly.” One can imagine two distinct scenarios in which the US follows similar fiscal paths.

On the gradual path, national debt and interest rates continue to rise and debt service accounts for an ever-increasing share of government revenues. As this squeezes out other spending, the political opposition to fiscal reform might eventually weaken so that a compromise can be found. But the government could also simply speed up borrowing to stave off budget cuts.

Further impetus to act might come from the impending exhaustion of the Social Security and Medicare trust funds, projected to occur within the next decade, which will require some sort of action to avoid large, legally mandated benefit

reductions. The response could include tax increases, benefit cuts, or both, as happened in 1983, the last time trust fund exhaustion was imminent. But the trust funds could also be bailed out simply through additional borrowing. The latter may be more likely this time, given the change in political climate.

Unless an agreement to act is reached in the coming years, the sudden path would follow the current trajectory until it is simply too expensive to borrow. Such an outcome seems far away at this point. The problem of unsustainable debt currently plagues many leading economies, and in this environment, the US may remain a safer haven for some time, providing an ever-larger supply of the assets world investors demand.

The US has a strong economy that could accommodate reforms to taxes and spending to achieve fiscal sustainability. There is no shortage of ideas to help shape such reforms. For the immediate future, though, it's hard to bet against a long, steady worsening of fiscal problems without a political realignment and restoration of the possibility of bipartisan action. **F&D**

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