Written by **Veronique de Rugy** on May 11, 2023

# Why the Debt Ceiling Continues to Matter

Veronique de Rugy

The debt-ceiling standoff has people concerned about what will happen if the U.S. defaults on its debt. I certainly hope both sides will come together to avoid this outcome. But it is still worth reminding everyone how incredibly precarious the status quo is, and why something needs to change.

You've heard the warnings about our debt levels, to the point where they might be easy to tune out. I make these all the time. When assessing how much we should worry, it's wise to look both at our current situation and where we're heading. This year, our budget deficit will likely be $1.4 trillion. What's more, the deficit will reach about $2.8 trillion in 2033. And that's assuming peace, prosperity, relatively low interest rates, no new spending and that some provisions of the 2017 tax cut will expire as scheduled.

That's $20 trillion in new borrowing over 10 years. So far, Uncle Sam has "only" accumulated $31 trillion in debt over the course of our entire history. But it gets worse fast. Congressional Budget Office projections show that the federal government will accumulate about $114 trillion in deficits over the next 30 years, which would place our debt at nearly 200% of GDP. Most of this predicted shortfall is due to Social Security and Medicare. Together these programs will consume 11.5% of GDP by 2035.

This is a lot of borrowing. In theory, it might not lead to a debt crisis *if* the government can find people to buy the debt at low rates or Congress develops a serious plan to repay it. Yet even assuming the best-case scenario, borrowing like this has a cost. Debt is a drag on economic growth, which means less tax revenue to pay it off.

A large debt also means higher interest payments. We already spend more on interest payments than on Medicaid, and 17.4% of our revenue goes toward interest payments. These payments will balloon to $1.5 trillion, or 22% of federal revenue, by 2033. Within 30 years, interest payments will consume half of all tax revenues. By then a lot of the spending that people like will be crowded out.

Even these estimates are rosy. They don't take into consideration the inflation that could result from all this debt accumulation. Most of our debt has a maturity of less than four years. As Congress gives up on controlling debt, once-confident investors might worry that the Fed will stabilize the debt with inflation. History provides some examples, and today's debt-to-GDP has fallen since the pandemic in part due to inflation. Investors, sooner rather than later, could demand higher interest rates as an inflation premium.

Research confirms the impact of debt on long-term interest rates. Every percentage point increase in

the debt-to-GDP ratio is associated with an increase of 3 basis points (0.03%) of the long-term real interest rate. So, if the debt ratio rises by 100% over the next 30 years, it will put upward pressure on interest rates of about 3 percentage points.

Because of the dollar's unique role in the global economy, the United States may have more legroom than other countries. Still, it's wise to worry that if the debt-to-GDP ratio rises from 94% to roughly 200% in three decades, we could face some serious interest-rate hikes.

If interest rates rise by just one percentage point, that will add $3 trillion in interest payments over 10 years, on top of the $10 trillion we're already scheduled to pay. That's an additional $30 trillion over 30 years. Add a few more interest-rate hikes and soon all your tax revenue is consumed by interest payments, not to mention the negative impact these rate hikes can have on the larger American economy.

A better question is this: Is it credible to bet on investors agreeing to buy $114 trillion in debt over the next 30 years? China and Japan have already reduced their holdings of American bonds, while the Fed already holds 25% of our debt. It's unclear that domestic investors will step up to the plate. What happens then? Taxes can only be raised so much. Under the current tax system, on average, the United States has raised about 18% of GDP in tax revenue. But in 30 years, spending will be 30% of GDP.

My hope is that if you've read this far, you now understand that Congress should start working diligently to stop our debt from growing.

No side is going to like what's required, but it must be done. And the longer we wait, the more painful it will be.

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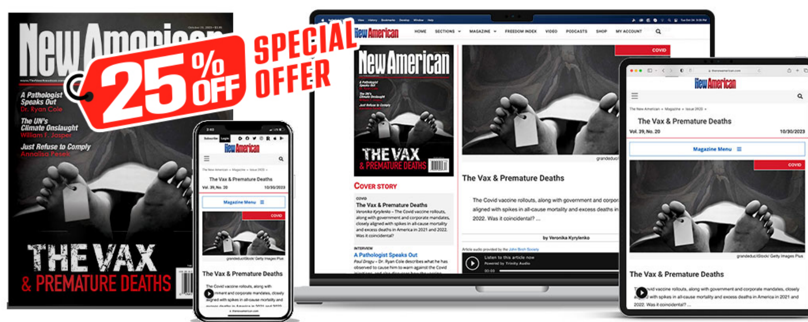


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