THE SHAPE OF THINGS TO COME

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Why the National Debt Still Matters

by

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About The Shape of Things to Come

Over the next few decades, the aging of America promises to have a profound effect on the size and shape of our government, the dynamism of our economy, and even our place in the world order. The Concord Coalition and the Global Aging Institute (GAI) have joined forces to produce a quarterly issue brief series that explores the fiscal, economic, social, and geopolitical implications of the aging of America. Although the series is U.S. focused, it also touches on the aging challenge in countries around the world and draws lessons from their experience. Concord and GAI hope that it will inform the debate over the aging of America and help to push it in a constructive direction. Concord wishes to express its gratitude to the Peter G. Peterson Foundation for the generous grant that makes the series possible.

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WHY THE NATIONAL DEBT STILL MATTERS

The federal debt held by the public has already passed 100 percent of GDP, up from 35 percent in 2007 on the eve of the Great Recession. According to the latest March 2021 CBO long-term budget projections, which do not take into account the recently passed American Rescue Plan Act or other new spending initiatives now being debated, it will hit 202 percent of GDP by 2051, nearly double the all-time record of 106 percent set at the end of World War II. And there are good reasons to believe that this projection is optimistic.

At least as startling as the debt projections themselves is the fact that so many economists seem to be unconcerned. We are not just talking about the adherents of Modern Monetary Theory (MMT), a fringe school of economic thought which claims that the national debt, whatever its size, is never a burden and never poses risks because the U.S. Treasury can always print more money to finance it. Even some prominent mainstream economists are now arguing that, in today's low-interest rate environment, the federal government can continue to safely run large structural budget deficits. Indeed, in a complete inversion of deficit hawks' traditional warnings against excessive indebtedness, they even suggest that not to do so would be to rob future generations.

The truth is that the United States is on a perilous fiscal course. While the federal government may now be able to safely borrow more than most economists once thought prudent, there is no way of knowing how much more. Proposals to up the ante on the national debt rest on a reckless gamble that interest rates will remain at historical lows, that the global appetite for U.S. debt will remain insatiable, and that, if these conditions change, the federal government can be counted on to act in a timely fashion to rein in deficit spending. The costs of miscalculation are enormous, and could include a global financial crisis, a domestic fiscal crisis, and the long-term erosion of U.S. living standards.

In this issue brief, we explain why it is wishful thinking to suppose that America can continue to run up the national debt as a share of GDP without placing its future at risk. We also explain why CBO's budget projections may greatly understate the future debt burden, and hence the dangers of failing to change course soon and decisively.

Conventional Wisdom

Mainstream economists, including even the most confirmed deficit hawks, have always acknowledged that there are legitimate and sometimes compelling reasons for the federal government to borrow. It may make sense for it to borrow to make investments that are likely to yield a long-term return that exceeds the interest rate on the debt issued to finance them, especially when those investments are ones that the private sector is unlikely to make. It may also make sense for it to borrow during economic downturns in order to finance stimulus spending, prop up aggregate demand, and push the economy back toward full employment. And it certainly makes sense for it to borrow as necessary during national emergencies. War is the most obvious example, but a global pandemic clearly qualifies.

Yet most mainstream economists also caution that a large and growing national debt can pose serious dangers. For one thing, government borrowing can crowd potentially more productive private-sector investments out of capital markets, undermining long-term economic and living standard growth. For another, rising interest costs can crowd spending on other priorities, including public investment, out of the federal budget. Capital market and budgetary "crowding out," moreover, are not the only dangers. If the demands of government borrowing become too great, it may trigger a spike in interest rates, further pulling down economic growth and further pushing up interest costs. If creditors lose confidence in the sustainability of U.S. fiscal and economic policy or come to suspect that the government will tolerate higher inflation in order to erode the value of the debt, they may begin to dump it. Since U.S. government debt plays a critical role in the stability of the international financial system, a large-scale selloff could trigger a global financial crisis. It could also trigger a domestic fiscal crisis if the government is forced to suddenly enact large tax hikes or spending cuts, perhaps in the midst of an economic downturn. One way or the other, it will be future workers and taxpayers who bear the costs in diminished living standards.

In short, conventional wisdom acknowledges that government borrowing has an important role to play in financing public investment, countercyclical spending, and national emergencies. But it also cautions that beyond a certain level of indebtedness the costs and risks of additional borrowing begin to grow rapidly. To be sure, that level is not permanently fixed in dollar terms or as a share of GDP, and a larger national debt may well be sustainable when interest rates are low and/or the rate of economic growth is high than when the opposite conditions prevail. But until recently, most mainstream economists erred on the side of caution and counselled against running large budget deficits except during economic downturns or national emergencies. And until MMT came along, no one claimed that the government can borrow as much as it wants under any circumstances without burdening future generations and without courting fiscal and financial crisis.

A Free Lunch on the Menu

MMT, which is as much a political movement promoting a progressive spending agenda as it is a school of economic thought, has its roots in a heterodox theory of money known as chartalism. Unlike the standard barter theory of money, which holds that money arose as a means of facilitating private economic exchanges, chartalism holds that money is purely a creation of the state and exists to serve the state's ends. This radically different understanding of the role of money in turn suggests a radically different understanding of government finances.[1] Mainstream economics, not to mention common sense, tells us that governments levy taxes in order to finance government activities. Not so, say the MMT theorists. Taxes exist to create demand for government currency, and may also be useful as tools for redistributing income, penalizing disfavored activities, and managing inflation. But governments do not need to levy taxes in order to spend money. All they need to do to spend money is to print it. Moreover, so long as a government's currency is a fiat currency—that is, a currency whose value is not pegged to some tradable commodity like gold—and so long as its debt is issued in its own currency, it can always print more money and create more debt to finance more spending on everything from free community college to national health care and the Green New Deal. According to MMT, the notion that there are any financial constraints on the federal government's ability to borrow and spend arises from a misunderstanding of how government finances really work.

In mainstream economics, running the printing presses to finance government spending is a recipe for inflation. The MMT theorists acknowledge that printing money can be inflationary, but insist that this is only the case if the economy is operating at less than full employment, which they redefine as zero unemployment. So long as there is any slack in the economy, printing money will boost economic growth without causing inflation. Within the MMT framework, moreover, the primary objective of government spending should be to achieve full employment, and government should spend whatever is required in order to do so, including offering a federal jobs guarantee. And what if government overshoots the mark, the economy overheats, and inflation takes off? No worries. The government can always cut spending or raise taxes, thus taking money out of the economy. In all of this, it is worth noting, the Federal Reserve (Fed) is missing in action. Within the MMT framework, monetary policy is not only ineffective, but irrelevant. The entire burden of managing the economy thus falls to fiscal policy.

While MMT has been embraced by some left-leaning members of Congress, it has failed to gain converts among mainstream economists, whatever their ideological persuasion. In a recent University of Chicago Booth School of Business poll of thirty-eight prominent economists, not one agreed with MMT's claim that governments which borrow in their own currency need not worry about the national debt because they can always print

[1] For the best known expositions of modern monetary theory, see Stephanie Kelton, *The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy* (New York: Public Affairs Books, 2020) and William Mitchell, L. Randall Wray, and Martin Watts, *Macroeconomics* (London: Red Grove Press, 2019).

more money to finance it.[2] It is perhaps not surprising that Kenneth Rogoff, co-author of *This Time Is Different*, a 2009 book that warns of the dangers of excessive indebtedness, calls MMT "smoke and mirrors" and "modern monetary nonsense." But even left-leaning economists who sympathize with MMT's progressive spending agenda are equally dismissive. Paul Krugman calls its claims "obviously indefensible." Larry Summers calls them "ludicrous"—and warns that MMT's policy prescriptions would lead to increased inflation, increased long-term interest rates, capital flight, and lower real wages.[3]

But if mainstream economists are in near universal agreement in rejecting MMT, some nonetheless believe that deficit spending can and should play a larger role in government finances than was thought to be advisable in the past. These economists, whose case is perhaps best articulated by Jason Furman and Larry Summers,[4] point out that, with private investment demand anemic and the world awash in excess savings, there is currently little reason to worry that government borrowing is crowding out private-sector investment. With interest rates at record lows, moreover, there is also no real danger of budgetary crowding out. Meanwhile, there is an urgent need for a wide range of new public investments, the return to many of which is likely to be greater than the interest rate, meaning that borrowing to finance them is justified.

Furman and Summers in particular further argue that, with real interest rates hovering around zero, monetary policy is no longer effective in combating recessions and ensuring full employment, so a more expansive fiscal policy is required. Nor should this more expansive fiscal policy be limited to managing the business cycle. Because of the secular slowdown in economic growth, due in part to population aging, structural budget deficits are called for. Not only is it safe for the federal government to run them, it would be economic folly for it not to do so, because the extra government spending is likely to increase GDP faster than it increases debt service costs, leaving future generations better off. And if circumstances

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[2] University of Chicago Booth School of Business, March 13, 2019, available at https://www.igmchicago.org/ surveys/modern-monetary-theory/.

[3] See Kenneth Rogoff, "Modern Monetary Theory Is Smoke and Mirrors Nonsense," *Project Syndicate*, March 5, 2019; Paul Krugman, "Running on MMT (Wonkish)," *The New York Times*, February 25, 2019; and Lawrence Summers, "The Left's Embrace of Modern Monetary Theory Is a Recipe for Disaster," *The Washington Post*, March 4, 2019.

[4] Jason Furman and Lawrence Summers, "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates," Discussion Draft, November 30, 2020, available at https://www.piie.com/system/files/documents/furman-summers2020-12-01paper.pdf. See also, Olivier Blanchard, "Public Debt and Low Interest Rates," *American Economic Review* 109, no. 4 (April 2019) and Paul Krugman, "Learn to Stop Worrying and Love Debt," *The New York Times*, December 3, 2020.

change and rising indebtedness becomes economically threatening? Well, the federal government can always raise taxes or cut spending later.

If all of this sounds a lot like what the MMT theorists are saying, that's because it does. MMT says that monetary policy is irrelevant, while the mainstream economists say that it is no longer effective. MMT says that deficit spending can't cause a crisis, while the mainstream economists say that it won't. Both, moreover, maintain that it will boost economic growth. And both maintain that if government miscalculates and its expansive fiscal policy turns out to be inflationary, it can always correct things by imposing fiscal austerity somewhere down the road. Yes, there are important distinctions between the MMT and mainstream arguments. But for all practical purposes, these are distinctions without a difference. Either way, a free lunch would seem to be on the menu.

What History Teaches

So why shouldn't the federal government issue more debt if doing so can create jobs, boost economic growth, and address pressing social needs? The answer is that the potential costs and risks are simply too high. To better understand why the temptation to keep borrowing at record levels is so great, as well as why we should resist it, it will be helpful to begin by taking a closer look at CBO's budget projections.[5]

What is perhaps most striking about them is how reassuring the near-term debt outlook seems compared with the long-term one. The CBO projects that the federal debt held by the public will reach 202 percent of GDP by 2051 and that net interest costs will by then be consuming nearly half of total federal revenue, a sobering enough prospect. Yet over the next decade, which is all that Congress ordinarily cares about, the debt initially falls from 102 percent of GDP in 2021 to 101 percent in 2024, then creeps up to 107 percent in 2031. Meanwhile, even as the federal government borrows an average of well over one trillion dollars each year, net interest costs as a share of total federal revenue only grow from 9 percent in 2021 to 14 percent in 2031, which is less than what they were during most of the 1980s and 1990s. (See figures 1 and 2.) Federal borrowing indeed seems virtually costless. The temptation is to conclude, well yes, we may need to rein in deficits in the long term. But the long term is inherently uncertain, and in the near term we seem to have plenty of room to borrow more—and plenty of time to change course if necessary.

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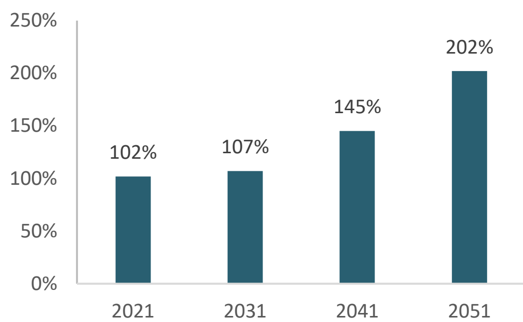
[5] The analysis in this issue brief is based on CBO's most recent long-term projections published in *The 2021 Long-Term Budget Outlook* (Washington, DC: CBO, March 2021). Some of the numbers cited for 2021 and the first ten years of the projection period therefore differ slightly from the latest numbers published in *An Update to the Budget and Economic Outlook: 2021-2031* (Washington, DC: CBO, July 2021).

But do we? The truth is that the debt burden may turn out to be much greater than projected, both near term and long term. For one thing, CBO's baseline, which must reflect the letter of current law, assumes that all tax cuts that are due to expire will indeed expire, even though Congress is likely to renew them. It also assumes that discretionary spending will merely keep pace with inflation over the next ten years, rather than grow along with GDP. Given rising labor costs, this may not be sufficient to fund current government activities, much less new priorities. Longer term, the projections assume a marked slowdown in the rate of growth in per capita health-care spending. They also fail to fully factor in recent declines in birthrates, which if they persist will feed through into slower labor-force and GDP growth.

Figure 1

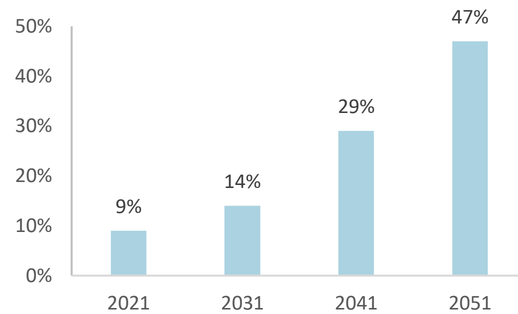
Publicly Held Debt as a Share of GDP, 2021-2051



Source: CBO (March 2021)

Figure 2

Net Interest as a Share of Federal Revenue, 2021-2051



Source: CBO (March 2021)

Let's ignore all of that, however, and focus on interest rates, where the choice of assumptions can have a much larger impact on the projected debt burden than almost anything else. Over the next ten years, the CBO projects that interest rates will remain at ultra low levels, with the "effective" nominal interest rate, or weighted average of interest rates on debt obligations of all maturities, averaging just 1.6 percent from 2022 to 2031. In real terms, the ten-year bond yield is projected to remain negative through 2025, which means that the CBO is assuming it will be negative for six straight years, by far the longest period of negative real rates since the 1940s. Such low interest rates generate huge compounding savings and explain why, despite massive new borrowing, net interest costs are projected to remain manageable as a share of federal revenue over the next ten years. In the longer term, the CBO projects that interest rates will rise again, but only gradually. It is not until the mid-2030s that the effective interest rate on the debt reaches 3.0 percent and not until the mid-2040s that it reaches 4.0 percent. In 2051, at the end of CBO's projection period, it stands at just 4.6 percent.

There are certainly good reasons to believe that interest rates may never again reach the much loftier levels which prevailed during the 1970s, 1980s, and 1990s. Over the past few decades, a number of structural demographic, economic, and policy shifts have combined to put downward pressure on interest rates, and particularly government bond yields. Slower growth in the labor force due to population aging has reduced the need for capital broadening investment, while a variety of factors, including the adoption of information technologies, have increased capital efficiency. Meanwhile, rising life expectancy, longer retirement periods, and increased income inequality have all tended to boost savings rates. This mismatch between investment demand and savings supply is of course a recipe for lower interest rates. At the same time, the adoption of inflation targets by many of the world's central banks has reduced inflation expectations, even as changes in bank regulations have increased the demand for "safe assets" like government bonds.

What is less clear is why the CBO assumes that borrowing will remain nearly costless for most of the 2020s. Ultra low interest rates might be expected during a period of rising unemployment, but that is not what the CBO is projecting over the next decade. They might also be expected during a period of slowing economic growth, but that is not what the CBO is projecting either. Perhaps the CBO is assuming that persistent ultra low interest rates in the rest of the high-income world will continue to drive savings here, where even ultra low rates are considered attractive because of the greater perceived safety of U.S. debt. But if so, how long can this be expected to last?

Any number of developments could cause interest rates to rise much sooner and faster than the CBO projects. It could be more rapid than expected economic growth here or abroad. It could be an acceleration in inflation that no longer appears "transitory." Or it could be a loss of global confidence in the long-term sustainability of U.S. fiscal and economic policy. Any or all of this, moreover, could happen very quickly, and by the time the warning lights are flashing red it may be too late to avoid wrenching fiscal adjustments. Historically, interest rates have often moved in lurches, falling or rising by several hundred basis points within just a few years. It is true that market watchers are not currently anticipating a sudden spike in interest rates, but their forecasts have missed past turning points more often than not.[6]

Given all of this uncertainty, it is important to consider what might happen to the debt burden in a less favorable interest rate scenario. The Concord Coalition's chief economist, Steve Robinson, has modeled one such illustrative scenario in which interest rates, though they rise no further than the CBO currently projects, rise much more quickly. Specifically, the scenario assumes that the ten-year bond yield will increase over

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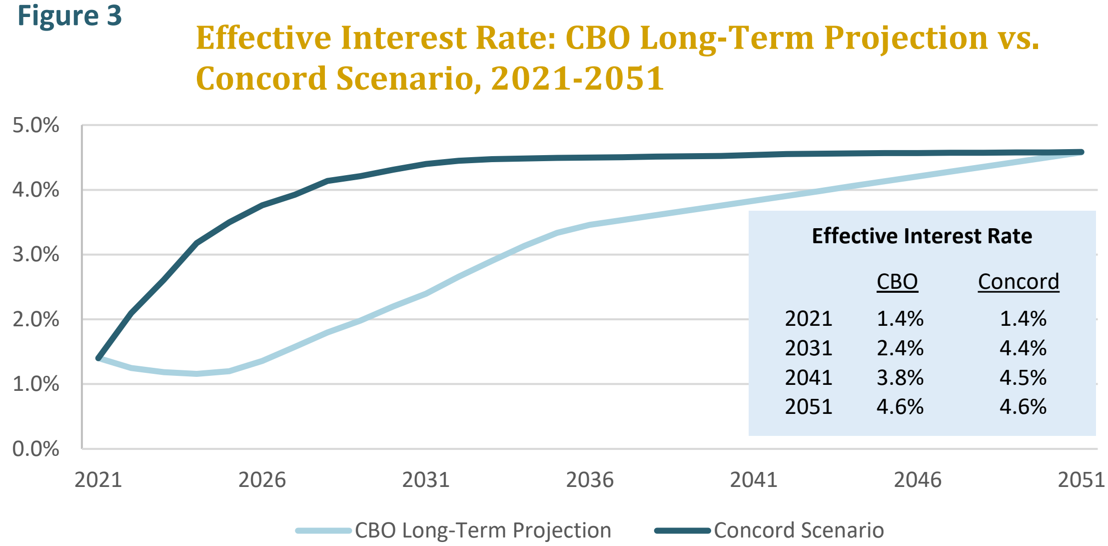
[6] See Edward Gamber, "The Historical Decline in Real Interest Rates and Its Implications for CBO's Projections," presentation at the 23rd Federal Forecasters Conference, May 6, 2021, available at https://www.cbo.gov/system/files/2021-05/57163-Interest-Rates.pdf

the next three years to 4.5 percent in 2024 and thereafter remain unchanged. While a yield of 4.5 percent is considerably higher than what the CBO is now projecting for 2024 (1.8 percent), it is worth noting that it is not that much more than what it was projecting as recently as 2019 (3.7 percent). Although the effective interest rate on the debt in Concord's illustrative scenario is no higher in 2051 than in CBO's projection, it naturally ramps up much more quickly as well.[7] (See figure 3).

Figure 3



Source: CBO (March 2021) and Concord calculations

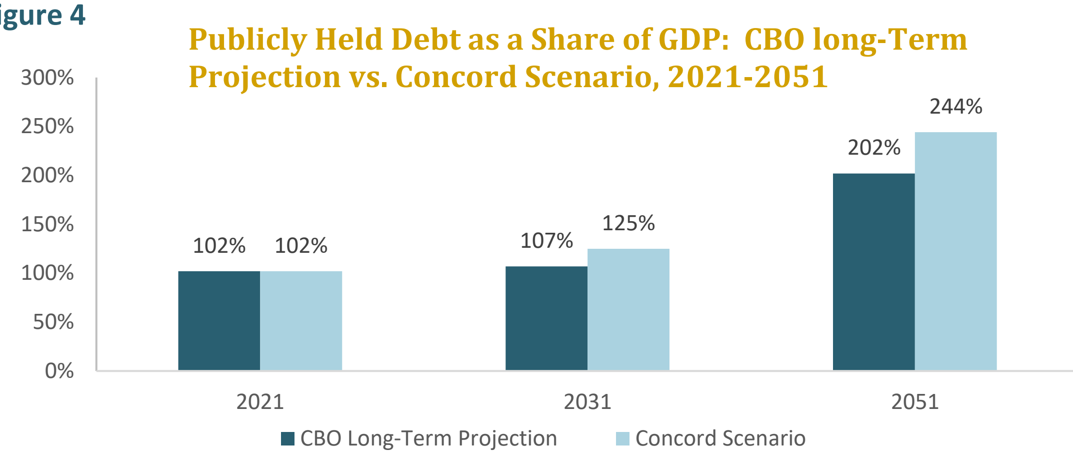
Note: Effective interest rates were calculated by Concord using the CBO definition, which is net interest payments on debt held by the public in the current fiscal year divided by debt held by the public at the end of the previous fiscal year.

The results are eye-opening. In Concord's scenario, the federal debt held by the public grows to 125 percent of GDP by 2031, much higher than the 107 percent the CBO projects. Meanwhile, net interest costs would already be consuming 29 percent of total federal revenue by 2031, compared with 14 percent in CBO's projection. All of a sudden, additional near-term borrowing doesn't seem quite so affordable anymore. Longer term, despite the fact that Concord's ultimate assumption for the ten-year bond yield (4.5 percent) is actually somewhat lower than CBO's (4.9 percent), the compounding effect of higher interest costs early in the projection period means that the publicly held debt would rise further than the CBO projects, reaching 244 percent of GDP in 2051. (See figures 4 and 5.)

[7] In Concord's illustrative scenario, annual primary budget deficits (that is, deficits excluding net interest costs) correspond to CBO's latest March 2021 long-term budget projections. The ten-year bond yield is assumed to rise from 1.1 percent in 2021 to 4.5 percent in 2024, and thereafter remain unchanged; the yield curve is assumed to immediately flatten; and all existing debt is assumed to be rolled over as scheduled. Although the path for interest rates in Concord's illustrative scenario differs significantly from that in CBO's latest long-term budget projections, the ultimate effective interest rate on the publicly held debt attained in 2051 (4.6 percent) is the same.

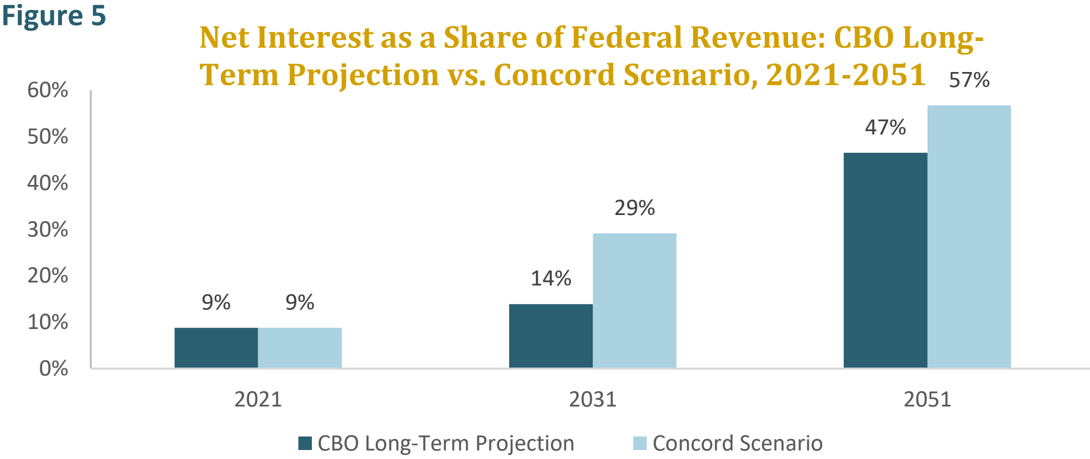
Concord's interest rate scenario is no more intended as a forecast than CBO's projection is. But it does serve the useful purpose of illustrating how uncertain the size of the future debt burden is. It could easily be higher than the CBO projects, and perhaps much higher. It could of course also be lower. But given CBO's ultra low near-term interest rate assumptions, the likelihood of that seems vanishingly small.

Figure 4



Source: CBO (March 2021) and Concord calculations

Figure 5



Source: CBO (March 2021) and Concord calculations

Whether America is heading for a fiscal or financial crisis is as uncertain as the debt projections themselves. But with the federal government due to issue $12 trillion of new debt over the next ten years under CBO's baseline projection, while also rolling over all of the old debt, it is worth asking the question: Who will buy it? The Fed, which owned 24 percent of the publicly held debt as of December 2020, may be happy to keep buying it, but only if inflation remains under control. Foreigners, who owned 33 percent, may also be happy to keep buying it, but only if they continue to trust in the long-term sustainability of U.S. fiscal and economic policy. That leaves the remaining 43 percent, which is held by state and local governments, institutional investors like pension funds and insurance companies, and the general public. At what point will they consider it too risky to keep loading their portfolios with federal securities as heavily as they now do and begin to seek alternatives? Maybe never, but no one knows.

This brings us to a final and too often overlooked risk in America's reckless debt gamble. When it comes to government finances, we have long enjoyed a privilege that no other country does. America's ability to borrow without seeming limit is not only made possible by today's ultra low interest rates, but is also underpinned by the status of the dollar as the global reserve currency. But what if the global financial system of 2030 or 2050 is structured differently than today's? Ten years, much less thirty, is a long time, especially in an era when the global economic and geopolitical landscape is shifting so rapidly. Do we really want to bet our children's and grandchildren's future on the assumption that the dollar will indefinitely enjoy the same privileged status?

If history teaches just two things about government debt and financial markets, they are, first, that there exists some level of debt beyond which new debt will no longer be financeable at tolerable interest rates, and second, that we cannot know in advance exactly what that level is. At the same time, if history teaches just two things about U.S. budget politics, they are, first, that it is easier to cut taxes than to raise them, and second, that new benefit programs, once enacted, are forever. These truths explain why it is a fantasy to suppose that we can continue to accumulate debt without grave risk to our economy and our future. A fiscal cliff looms somewhere over the horizon. But we do not know where it is, and we may not be able to step back from the brink when we reach it.

A Long-Term Strategy

Neither The Concord Coalition nor the Global Aging Institute disputes that the federal government can safely carry a larger national debt than was once thought to be prudent. Nor do we dispute that there are important unmet needs that the federal government could and should address. What we do dispute is that borrowing has become costless and riskless.

The usual economic constraints on deficit spending may have been suspended for a while, but they have not been repealed. As the U.S. population ages over the next few decades, the federal budget will come under intense pressure from rising retirement and health-care spending. Ideally, America would be approaching this fiscal gauntlet with the national debt low and falling as a share of GDP. Instead, the national debt is near an all-time high and rising. America's leaders urgently need to develop a long-term budget strategy that stabilizes the national debt as a share of GDP. If they delay much longer, it may be too late.

About the Global Aging Institute

The Global Aging Institute (GAI) is a nonprofit research and educational organization dedicated to improving our understanding of global aging, to informing policymakers and the public about the challenges it poses, and to encouraging timely and constructive reform. GAI's agenda is broad, encompassing everything from retirement security to national security, and its horizons are global, extending to aging societies worldwide.

GAI was founded in 2014 and is headquartered in Alexandria, Virginia. Although GAI is relatively new, its mission is not. Before launching the institute, Richard Jackson, GAI's president, directed a research program on global aging at the Center for Strategic and International Studies which, over a span of fifteen years, played a leading role in shaping the debate over what promises to be one of the defining challenges of the twenty-first century. GAI's Board of Directors is chaired by Thomas S. Terry, who is CEO of the Terry Group and past president of the International Actuarial Association and the American Academy of Actuaries. To learn more about GAI, visit us at www.GlobalAgingInstitute.org.

About The Concord Coalition

The Concord Coalition is a nationwide, non-partisan, grassroots organization advocating generationally responsible fiscal policy. It was founded in 1992 by former Senator Paul E. Tsongas (D-Mass.), former Senator Warren B. Rudman (R-N.H.), and former U.S. Secretary of Commerce Peter G. Peterson with a non-partisan mission to confront the nation's long-term fiscal challenges and build a sound economy for future generations. The Concord Coalition's national field staff, policy staff, and volunteers carry out the organization's public education mission throughout the nation.

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