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U.S. Long-Term Debt Situation Is One of the World's Worst

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This year, the U.S. public debt is projected to reach 62 percent of the economy—up from 40 percent in 2008 and nearly double the historical average, according to recent Congressional Budget Office (CBO) estimates. The financial crisis and recession drove much of this debt swing, yet larger problems loom in the future.

By 2030, the CBO projects that debt will more than double to 146 percent of GDP.[1] The only good news, if it can be called that, is that the U.S. is not alone. Two recent studies by the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) highlight the significance of the global debt challenge and stress the need for governments to aim higher than short-term deficit reductions. For the U.S., one of the most poorly positioned countries, addressing the long-term debt challenge must include prompt reform of Social Security, Medicare, and Medicaid.

On the Edge of the Debt Cliff. Since 2007, nations across the globe have been following a recipe for rising debt. Government financing surged to ameliorate the global financial crisis, amounting to 13.2 percent of industrialized countries' GDP.[2] Meanwhile, a worldwide recession caused revenues to drop, growth to slow, and politicians to pursue false hopes that lavish stimulus spending would somehow stop the bleeding. These anti-recessionary efforts drove advanced economies' deficits collectively up to 20–30 percent of GDP in three years.[3]

The numbers are alarming enough, but as the BIS points out, the most damning aspect is that these deficits are now baked into the cake—otherwise known as structural deficits—and will persist even when economies recover. A short-term focus on deficit reduction, such as G20 nations' pledges to halve deficits by 2013, will do little to pull nations back from the brink. The U.S. domestic situation is so severe that a fiscal adjustment of 12 percent of GDP would be required to stabilize debt at 60 percent of GDP, which is even higher than Greece's 9.2 percent adjustment.

The main driver of medium- and long-term liabilities is that governments are on the hook for trillions in unfunded age-related spending for pension and health care obligations. Over the next 20 years, the U.S. will experience the second highest projected increase of all the G20 countries in health care and pension spending as a share of GDP.[4]

To assess the impact of age-related spending, the BIS ran three spending scenarios to project debt through 2040 in 12 countries. In all scenarios debt was found to reach unsustainable levels.[5]

The first scenario followed the status quo in which countries' public debt ranged from 250 percent to 600 percent of GDP. The second scenario introduced gradual adjustments that would halve

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deficits in the short term, yet debt still reached levels ranging from 100 percent to 400 percent. The third scenario added an age-related spending freeze (at 2011 levels) to scenario two, and only four countries (Italy, Germany, Austria, and the Netherlands) lowered debt levels below 100 percent of GDP.

The U.S. was one of the worst performers, reaching debt levels in each scenario of 450, 300, and 200 percent of GDP, respectively. That debt is primarily driven by the unfunded obligations held by Social Security, Medicare, and Medicaid.

Off the Edge of the Debt Cliff. One of the largest challenges BIS predicts nations will face is that economic output is unlikely to fully recover after global recession ends. Deficits will likely persist, causing the debt-to-GDP ratio to rise steadily. This would result in serious economic pains.

First, upward pressure will be put on interest rates. As sovereign debt rises, more resources will be required to purchase it, and the risks associated with potential loss will rise. As a result, debt buyers will require better interest premiums. In an earlier study, the IMF has estimated that a 10 percentage point increase in the debt ratio would cause interest rates to rise by approximately 50 basis points.[6] For the U.S., interest rates could climb by 2 full percentage points, which would cause the cost of debt to explode over the long term.

Second, as more economic resources are required to service a country's debt, fewer resources are available for the private sector to invest in productive capital. For countries like the U.S. that borrow excessively from abroad, this problem will be exacerbated because debt service payments will be paid outside the U.S. economy. The IMF estimates that a debt increase of 10 percentage points depresses investment as a percentage of GDP by roughly 0.4 points.[7]

Third, the drop off in investment slows economic growth. An increase in the debt-to-GDP ratio of 10 percentage points would slow growth by 0.15 to 0.2 percentage points per year, according to the IMF.[8] While that number may seem slight, compounded over several years, the impact becomes severe.

Finally, significant inflationary pressure will result from high levels of debt. On one hand, if debt buyers lose their appetite for buying debt, then monetary authorities would have to print money to continue to fund the debt. On the other hand, inflation could be used to erode the value of existing debt by lowering the real value of currency and, thus, the real value of the stock of debt.[9] Indeed, inflation was partly responsible for enabling the U.S. to bring down its debt so rapidly after World War I.[10] Either way, the result is bad for consumers and savers, who see their purchasing power and savings drop.

1. Congressional Budget Office, "Long-Term Budget Outlook," June 2010, at *http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf* (July 22, 2010).
2. Stephen G. Cecchetti *et al.*, "The Future of Public Debt: Prospects and Implications," Bank for International Settlements, March 2010, p. 6, at *http://www.bis.org/publ/work300.pdf* (July 26, 2010).
3. *Ibid.*, p. 4.
4. International Monetary Fund, *Navigating the Fiscal Challenges Ahead* (Washington, D.C.: International Monetary Fund, 2010), at *http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf* (July 22, 2010). The top three countries are Russia (5.9 percent), United States (5.8 percent), and Germany (4.9 percent).
5. The countries evaluated were Austria, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Portugal, Spain, the United Kingdom, and the United States.
6. IMF, *Navigating the Fiscal Challenges Ahead*, p. 29.
7. *Ibid.*
8. *Ibid.*
9. Raising interest rates could not counteract inflationary pressures because the increase in rates would further necessitate an increase in interest payments on the debt, creating a vicious circle that would drive debt higher still.
10. Joshua Aizenman and Nancy Marion, "Using Inflation to Erode the U.S. Public Debt," *NBER Working Paper* No. 15562.

With such significant consequences at stake, it is no wonder that the IMF monitors government debt levels very carefully. By 2015, advanced economies are projected to carry an average debt of 110 percent of GDP, with the U.S. trailing at 83 percent. While that is not as bad as Greece, for instance, debt that approaches 100 percent of GDP can trigger an IMF audit. This would be a fiscal embarrassment that would erode U.S. global economic leadership.

Preventing the Fall. The BIS stresses that "consolidations along the lines currently being discussed [by global leaders] will not be sufficient to ensure that debt levels remain within reasonable bounds over the next several decades."[11]

Most strikingly, it also notes that tax increases would most likely not close the gap, either: "Given the level of taxes in some countries, one has to wonder if further increases will actually raise revenue."[12]

For the U.S., legislative and policy reforms to Social Security, Medicare, and Medicaid should include the following:

- *Report long-term obligations.* Congress fails to report the unfunded obligations of entitlements in its annual budget. This number should be prominently disclosed in the budget, and Congress should be required to have a stand-alone vote on any policy that would substantially add to that number.
- *Create long-term budgets for entitlements.* Entitlements grow on autopilot, without annual review, and have first call on federal dollars. Instead, entitlements should be placed on limited, 30-year budgets that would be reviewed and debated by Congress every five years. This would put entitlement spending on a level playing field with other priorities and force Congress to spend within its means.
- *Make retirement programs fair but affordable.* Entitlement spending promises debt-financed benefits for all retirees, regardless of income. Meanwhile, a welcome increase in life expectancy has resulted in unwelcome years of unaffordable benefits. To resolve these issues, entitlements should be better targeted to those most in need, and the eligibility age for these programs should be increased with longevity.

Avoiding Disaster. The warning shots fired by the IMF and BIS should be a wake-up call to global leaders to get public debt under control. The economic consequences of projected debt, if realized, would be devastating, and the prospect of triggering an IMF audit is embarrassing at best and politically untenable at worst.

In the U.S., the best way to prevent this disaster is to start with serious and prompt reform to age-related spending in Social Security, Medicare, and Medicaid entitlements.

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11. Cecchetti *et al.*, p. 9.
12. *Ibid.*, p. 13.