EXECUTIVE SUMMARY

Eight Questions—and Some Answers—on the US Fiscal Situation

By Jason Furman

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Introduction

The high level of US debt poses significant threats to the US economy and fiscal position. The consequences of inaction are potentially severe but highly uncertain. In this paper, Furman addresses eight specific questions essential to understanding the US fiscal situation and what policymakers can do to address the US debt burden. He highlights the uncertainties in forecasts, observing that uncertainty argues for taking precautionary action sooner rather than later. He contends that an adjustment of between 0.7 and 4.6 percent of GDP is necessary to stabilize the debt over the next decade, and he proposes an actionable set of reforms to achieve such an adjustment, including tax reform, PAYGO conditions for new spending programs, and reforms to Social Security and Medicare.

1. Is the US fiscal situation sustainable?

The US fiscal situation is unsustainable. In fiscal years 2022, 2023, and 2024, the US ran an average deficit of 6 percent of GDP, despite a strong economy. The Congressional Budget Office (CBO) projects that the debt will reach 98 percent of GDP at the end of 2024, higher than in any year outside 1945, 1946, and 2020.

The CBO expects the deficit—excluding interest payments on the debt (the primary deficit)—to improve over the next decade, but that development will be offset by higher interest rates leading to larger interest payments on the debt. Further, the projected drop in the primary deficit comes entirely from higher tax rates and other tax changes scheduled to go into effect mostly in 2026, as most of the individual tax provisions in the Tax Cuts and Jobs Act (TCJA) of 2017 will expire under current law. If this assumption is violated, the debt would rise even faster as a share of GDP. Under a combination of alternative policy and economic assumptions—including the extension of current tax and spending policies, greater productivity growth, and higher interest rates—the fiscal path remains unsustainable: By 2030, the federal deficit will range from 6 to 10 percent of GDP, and the debt would reach between 111 and 141 percent of GDP.

2. Where does the debt need to stabilize?

Furman emphasizes the need for debt stabilization to avoid scenarios where the central bank might need to monetize the debt or default on it, both of which scenarios would have severe economic consequences. Surveying historic debt crises, Furman concludes that it is difficult to pinpoint the precise level of debt beyond which negative outcomes occur but that debt stabilization at some level is critical. Furthermore, to stabilize that debt at some level, the policy path would have it decline during normal times, in anticipation of its ratcheting up during emergencies.

3. How large an adjustment is needed for the debt to stabilize a decade from now?

The estimated amount of deficit reduction needed to stabilize the debt by 2034 depends on the path of policy and on economic variables (such as interest rates and productivity growth). Under the scenarios Furman explores in this paper, an adjustment of 0.7 and 4.6 percent of GDP in higher taxes or lower noninterest spending is necessary to stabilize debt over the next decade (equivalent to between $2 trillion and $11 trillion in adjustments). Under the CBO's economic and policy assumptions, a fiscal adjustment of 2.5 percent of GDP annually ($6 trillion over ten years), would stabilize the debt at 122 percent of GDP by 2034.

4. Has our fiscal challenge gotten worse in recent years?

Furman argues that the fiscal challenge may be more severe now than it was immediately before COVID-19, depending on the outlook on interest rates. Looking forward, the combination of better primary-deficit and worse interest-rate forecasts means that the deficit reduction needed to stabilize the debt as of June 2024 is basically unchanged from the pre-COVID forecast, using CBO figures. Financial markets, however, are expecting even higher interest rates than the CBO, and using those forecasts the financial picture has worsened dramatically. Moreover, using either the CBO or market forecasts, the fiscal challenge has certainly worsened compared to its pre-2020 state.

5. What would it take to cut spending or raise taxes by this amount?

Furman reviews the likely impact of a menu of possible tax and spending proposals, highlighting several key takeaways. First, revenue from corporations and high-income individuals is not sufficient to close the fiscal gap. For instance, such provisions in the Biden administration's 2025 budget would raise about 1.3 percent of GDP in revenue. A more aggressive set of proposals would likely run into Laffer-curve constraints before revenues reached 2 percent of GDP.

Second, extending the 2017 tax cuts would add another 1.5 percent of GDP to the fiscal gap, substantially exacerbating the situation. Third, outside of cuts to Social Security, not even relatively dramatic spending cuts in other programs would come close to reducing the deficit by even 1 percent of GDP: A uniform 20 percent cut to income security programs such as TANF, SNAP, SSI, and housing vouchers would reduce spending by 0.4 percent of GDP. Finally, restoring solvency to Social Security and Medicare through tax or benefit changes would close about 1.5 percent of the current law deficit.

Furman concludes that a broad set of tax increases and/or spending cuts will be required to stabilize the debt.

6. What will happen if policymakers do not make a fiscal adjustment?

While the "known knowns" of sustained high rates of US debt, such as higher interest rates, are not particularly large, the "unknown unknowns" are potentially much larger and even more consequential. Persistent debt accumulation could lead to higher interest rates and crowd out private investment, which would in turn lower economic growth, but these channels are quite small according to conventional economic models. Furman highlights three other scenarios that strengthen the case for more immediate fiscal action.

First, delaying action on fiscal sustainability necessitates larger adjustments over a shorter time frame. As policymakers postpone addressing the issue, they face a shrinking window of opportunity to implement changes, thus requiring more substantial measures. Moreover, a delay could exacerbate interest rate increases, necessitating even more significant adjustments to stabilize the fiscal situation. Second, there is the risk of inadequate fiscal space for future emergencies. During the global financial crisis and the

COVID-19 pandemic, periods when substantial US debt was incurred, the Treasury was able to borrow as needed. However, there are growing concerns about whether the Treasury will have access to the necessary liquidity in the future, should debt levels rise acutely. Third, though the likelihood of a fiscal crisis may seem low, its potential consequences would be severe.

Policymakers should be prepared to invest significantly in risk prevention to avoid a fiscal crisis, acknowledging that the costs of such a crisis could be exceedingly high.

7. What are the consequences of uncertainty about the magnitude and economic impact of the fiscal outlook?

There is significant uncertainty surrounding the outlook for the US deficit and the impact of not acting quickly. Furman argues that these uncertainties highlight two key considerations for decision-making. Firstly, policymakers should act proactively to minimize risk. Even if a fiscal crisis does not occur, reducing its likelihood is valuable. Conversely, waiting to take concrete action may be beneficial. This delay would allow for more comprehensive information to be gathered about the problem's scope and the required solutions.

At a minimum, the combination of these countervailing considerations says that we should do no harm. Nevertheless, it would require an unlikely, though not impossible, set of circumstances for the debt to stabilize as a share of the economy without policy changes.

8. What could cause policymakers to act?

While obstacles to fiscal action are substantial, stemming from low public concern for the debt and features of the American political system, Furman outlines three possible impetuses for policymakers to act. First, he argues that increased political support for deficit reduction, or the backing of a political candidate who reinvigorates the conversation around deficit reduction, has the potential to shift political focus toward the debt situation. Second, a fiscal event could potentially catalyze action from policymakers. The 2025 expiration of the TCJA tax cuts, or the exhaustion of the combined Social

Security and Medicare trust funds, projected for 2035 and 2036, respectively, could trigger action. Finally, an economic forcing event, such as a substantial rise in interest rates, could compel action.

Policy Recommendations

Furman recommends that policymakers balance the primary budget, which excludes interest payments, by 2030. Achieving this goal would stabilize the debt at 125 percent of GDP and, under both CBO and market interest rate forecasts, would keep interest payments below 2 percent of GDP. Debt would then, in turn, start to gradually fall as a percent of GDP—which is essential, given that periodic emergencies (such as wars, financial crises, and pandemics) ratchet up the debt-to-GDP ratio.

To achieve this outcome, he proposes that policymakers undertake the following four measures:

1. Do not pass any new tax legislation in 2025, unless it includes a reform plan that increases revenues by 0.5 percent of GDP relative to current law.

2. Implement a Super PAYGO system for all future legislation, where savings would exceed costs by 25 percent.

3. Reform Social Security and Medicare to ensure the trust funds' solvency for the next 75 years.

4. Allow for flexibility to address economic and international emergencies.

ABOUT THE AUTHOR

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Jason Furman is the Aetna Professor of the Practice of Economic Policy jointly at Harvard Kennedy School (HKS) and the Department of Economics at Harvard University. He is

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