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Federal Deficits and Debt: Challenges for the Decade Ahead

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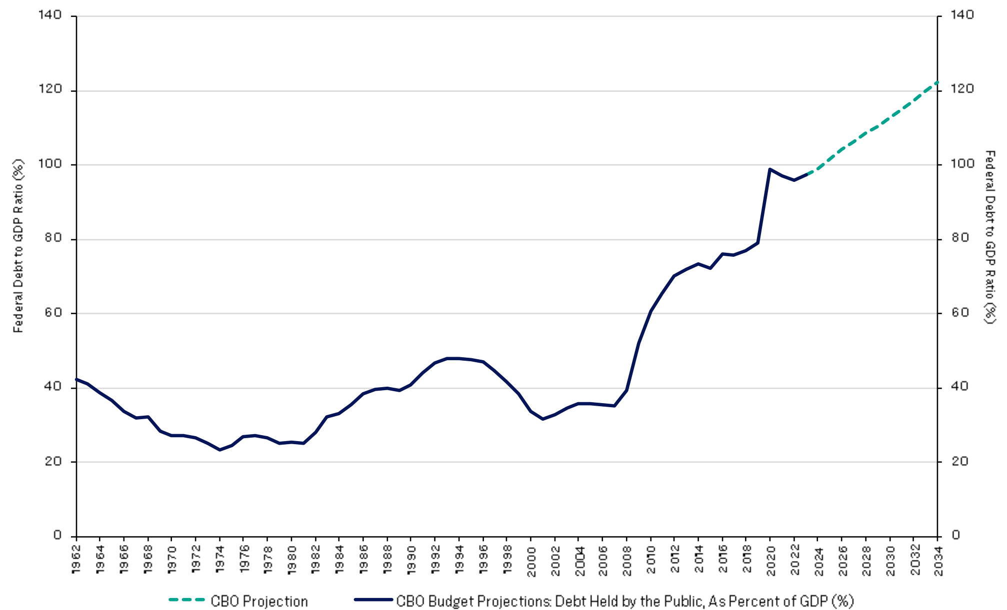
For all but a few of the past 80 years since the end of WWII, the U.S. federal government has spent more money than it has taken in. In doing so year after year, the central government has amassed a debt (the cumulative sum of all those annual deficits) of more than $26 trillion dollars. At 97% of gross domestic product (GDP), the debt-to-GDP ratio at the end of fiscal year 2023 was the highest since the years just after WWII; the Congressional Budget Office (CBO)—a nonpartisan arm of Congress that provides analysis of budgetary issues for lawmakers—is projecting it to rise to 122% by the end of 2034 (Figure 1).

Figure 1

Federal debt-to-GDP ratio is projected to rise steadily over the next decade.



Source: Office of Management and Budget, CBO, TIAA Wealth Chief Investment Office

Periodically over the past 30 to 40 years, the U.S. federal debt burden has been a concern to financial markets, but the massive run-up in spending during and after the COVID-19 pandemic has once again pushed the deteriorating U.S. fiscal situation to the top of the list of worries for investors, most notably, in the bond market. Moreover, outside the U.S., fiscal concerns are mounting as well, amid tepid economic growth, rapidly aging populations, and rising interest rates.

In this report, we examine the purpose of fiscal policy, the catalysts driving the worsening deficit and debt situation around the world, how we got here, the macroeconomic and societal implications of runaway deficits and debt, why it all matters for markets and the economy, as well as possible solutions to address the myriad challenges.

Over the last 75 years, the federal government has used fiscal policy (spending increases/tax cuts) to help balance out the impact of economic slowdowns and recessions. This is sometimes referred to as countercyclical policy. Monetary policy (establishing interest rates, controlling the money supply, etc.) is also used to help manage the ups and downs of the economy. Fiscal policy is set by

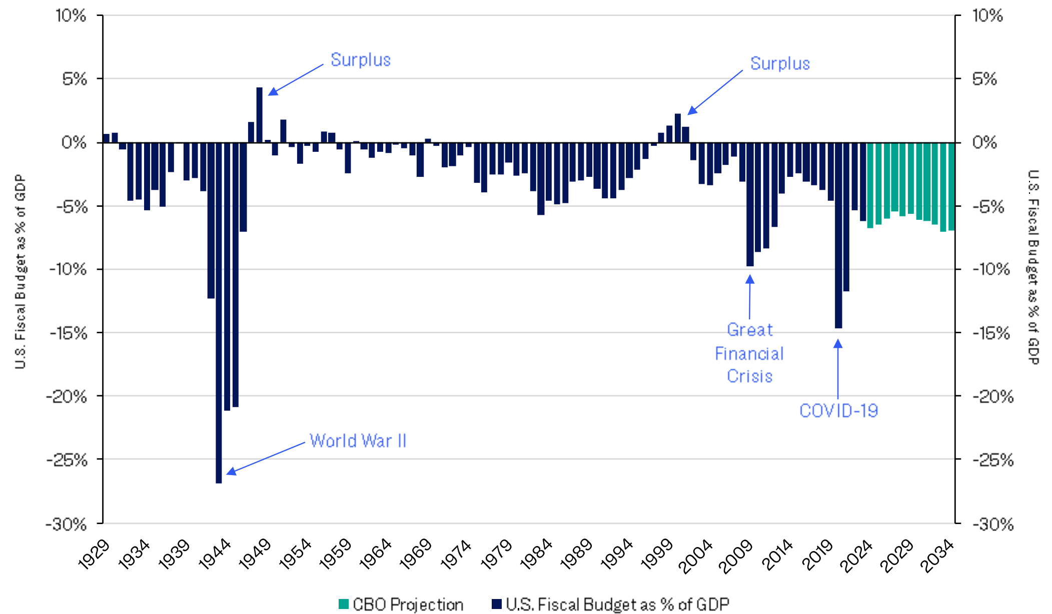
Congress along with the Executive Branch (aka the President). Monetary policy is set by the Federal Reserve (Fed), which is overseen by Congress.

Together, fiscal and monetary policy act as stabilizers for the U.S. economy as it is buffeted by various headwinds and tailwinds. However, more recently, federal government spending continues unabated even as its traditional countercyclicality would have implied an improving fiscal budget given the health of the economy. Since 2022, the U.S. budget deficit has averaged 6.6% of GDP even as the unemployment rate has not exceeded 4%. As the Fed hiked interest rates to contend with a spike in inflation, those debt burdens remain as an increasing source of concern that could ripple through the bond market.

How we got here

The U.S. federal government has run an annual budget surplus in only a handful of years since the end of WWII: in 1970, several years in the late 1990s, and early 2000s (Figure 2). In all other years, federal spending on items like defense, Medicare, Social Security, interest payments on the debt, international aid, etc. have exceeded revenues taken in by the government from personal, corporate, payroll and excise taxes and tariffs. Spending on mandatory programs, the largest of which are Social Security, Medicare, and Medicaid, accounts for 61% of federal spending, while spending on discretionary items like national defense, security, law enforcement, education, transportation, national parks, disaster relief, foreign aid, etc. accounts for 28% of spending. Net interest accounts for 11% of spending (Figure 3).

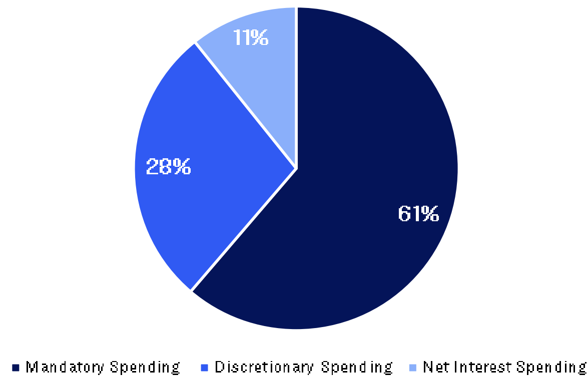
Figure 2
U.S. budget deficit/surplus (percent of GDP).



Source: Office of Management and Budget, CBO, TIAA Wealth Chief Investment Office

Figure 3

Total federal outlays. Mandatory spending on programs like Social Security, Medicare, and Medicaid is 61% of the federal budget.



Source: U.S. Treasury, TIAA Wealth Chief Investment Office

In the latest fiscal year[1] (2023), the U.S. federal government spent $6.1 trillion and collected $4.4 trillion in revenues from taxes and fees. The resulting deficit was $1.7 trillion, or 6% of GDP. Each year, the U.S. Treasury is forced to borrow (issuing bills, notes, and bonds to the public) in order to bridge the gap between revenues and spending (Figure 4). Expressing budget figures as a percent of GDP is common and allows for better comparisons between historical and current data, and between the U.S. and countries outside the U.S.

Figure 4

The gap between federal spending and tax revenues is projected to widen in the next decade.

	2023 (Actual)	2034 (Projected)
Total Spending	$6.1T	$10.3T
Mandatory (% of total spending)	61%	62%
Discretionary (% of total spending)	28%	22%
Net Interest (% of total spending)	11%	17%
Total Tax Revenue	$4.4T	$7.5T
Individual Income Taxes (% of total revenue)	49%	54%
Payroll Taxes (% of total revenue)	36%	33%
Corporate Income Taxes (% of total revenue)	9%	7%
Other Taxes (% of total revenue)	5%	6%
Total Deficit*	$1.7T	$2.8T

*Financed by issuing Treasury bills, notes, and bonds

Source: Office of Management and Budget, CBO, TIAA Wealth Chief Investment Office

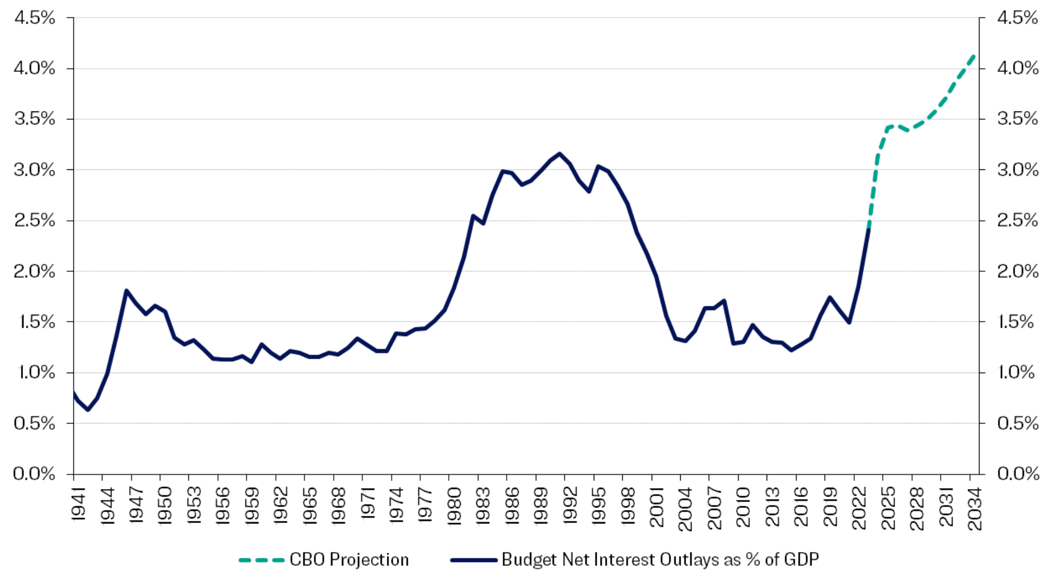
The spending on mandatory budget items (61%) is set by law and largely driven by demographics, health care costs, and longevity. These programs are not subject to the annual appropriations process in Congress. As a result, changing the trajectory of the spending associated with these programs is difficult, at best. Meanwhile, the discretionary spending items (just 28%) are the result of the annual budgeting process that occurs each year in Washington. The process is quite fractious and involves tense negotiations over political issues that, increasingly in recent years, lead to government shutdowns, debt ceiling debates and other events that markets generally don't like. Taken together, mandatory and discretionary spending determine the nation's primary surplus (or deficit). Over time, mandatory spending has overtaken discretionary spending as the main driver of

[1] Fiscal years run from October 1 to September 30. The 2023 fiscal year began on October 1, 2022 and ended on September 30, 2023.

the federal deficit. Moreover, interest payments on the federal debt are rising rapidly, and that trend is expected to persist in the coming decade, absent any changes in policy (Figure 5).

Figure 5

Interest payments are rising rapidly and are projected to maintain the trend.

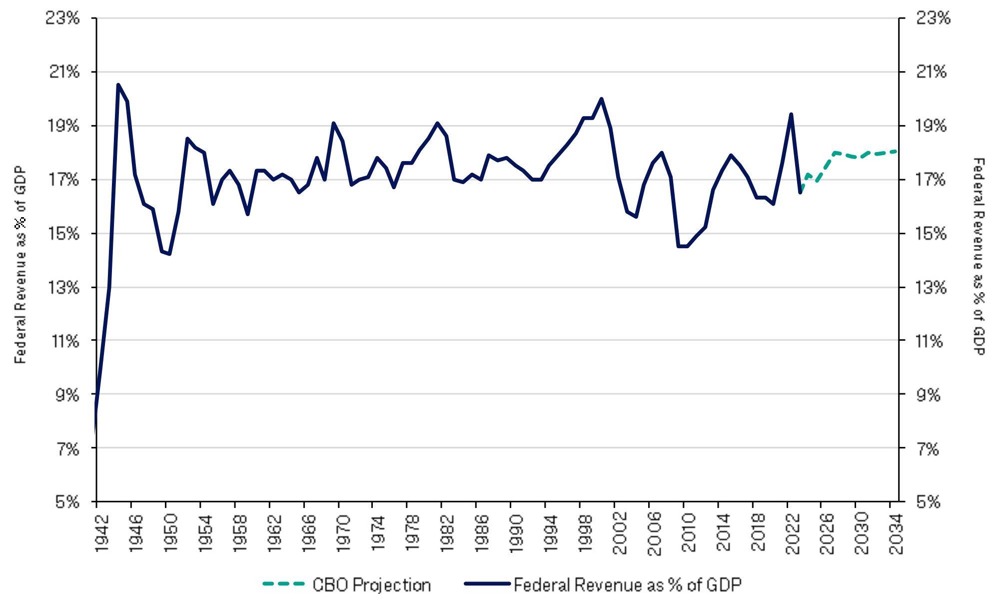


Source: U.S. Treasury, TIAA Wealth Chief Investment Office

Net interest payments are what the federal government pays to the holders of the bills, notes and bonds it issues through the U.S. Treasury to make up the difference between revenues and spending. In 2023, U.S. interest payments on its accumulated debt amounted to a staggering $659 billion, or 2.4% of GDP and the CBO projects that will increase to nearly 3.5% by 2030, surpassing the previous high of 3.2% set in the 1980s. Moreover, CBO estimates that debt and interest payments will continue to grow, with federal spending expected to jump 64% to over $10 trillion, compared with $6.1 trillion in 2023.

On the revenue side, the federal government collects taxes on income, payroll taxes (Social Security, Medicare, and Medicaid), and corporate taxes. Income taxes account for 49% of revenues, 36% comes from payroll taxes, and corporate taxes account for 9% of revenues. Excise taxes, estate taxes, and customs duties account for the remainder of federal expenditures. In the past 50 years, the mix of revenues from personal, payroll, corporate and other taxes has remained relatively steady, though there are ebbs and flows depending on the health of the overall economy (Figure 6).

Figure 6
Federal revenue as a percent of GDP is projected to flatten.



Source: U.S. Treasury, TIAA Wealth Chief Investment Office

Why fiscal sustainability is not just a U.S. problem

Internationally, the fiscal situation is even more dire than in the U.S. in some cases.

- Since Q4 2007, the eve of the Great Financial Crisis, the average debt-to-GDP ratio of all G20 member countries has risen from ~51% to ~81%, after being remarkably stable over the prior 15 years. Global governments have faced two major economic downturns that have required significant spending to correct financial and economic imbalances in 2008, and to support consumption during the pandemic. Spending on social and retirement entitlements has grown exponentially, in line with an aging population. Meanwhile, budget revenues have declined globally as a share of GDP due to lower tax rates and slower income growth.

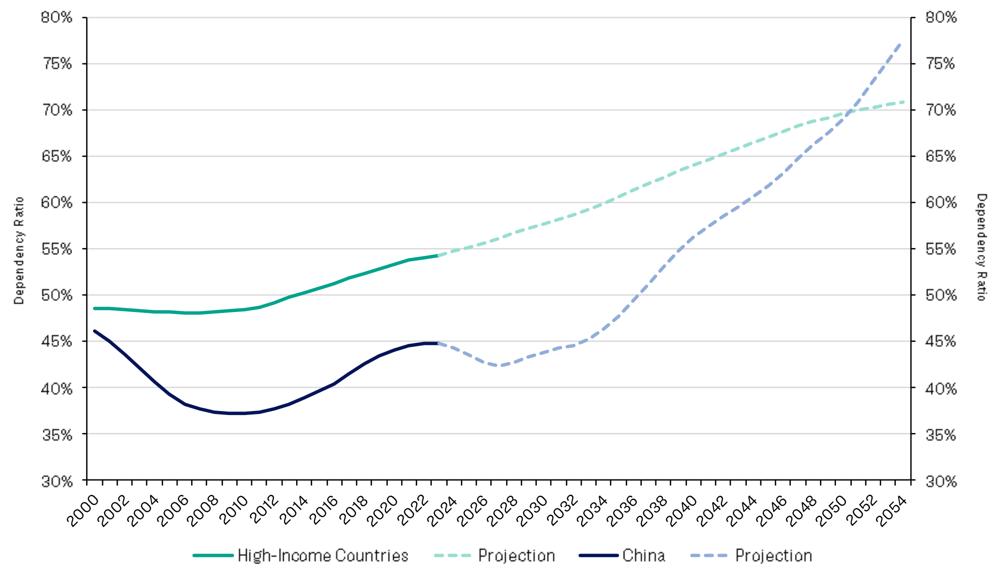
- As we discussed in our Focus*Point* article titled "2024: A Pivotal Year for Global Democracies, Markets, and Economies," around half of the world's population is heading to the polls in 2024. Politics have catalyzed investors' attention on the issue of fiscal sustainability, especially as parties that run on a platform of generous fiscal spending and tax relief are enjoying broadening support throughout the world. France provides a relevant example for how once-fringe parties are now gaining votes from moderates as they promise popular, yet unsustainable fiscal reforms such as a lower retirement age and an expansion of existing retirement benefits.

- Demographic trends represent a material headwind to fiscal discipline, with no easy fix. The productive share of the population is shrinking in most of the developed world and in some notable emerging countries as well, including China (Figure 7). The dependency ratio[2] in high-income countries will spike from 54% to 70% over the next 30 years, and the increase will be even more dramatic in China (from 44% to 71%). This means that the taxable base as a share of those who receive social and welfare benefits will continue to decline, accelerating the need for structural fixes to tax codes and entitlement programs.

[2] The number of dependents aged zero to 14 and over the age of 65, compared with the total population aged 15 to 64.

Figure 7

The dependency ratio in high-income countries will spike over the next 30 years, accelerating the need for structural fixes to tax codes and entitlement programs.



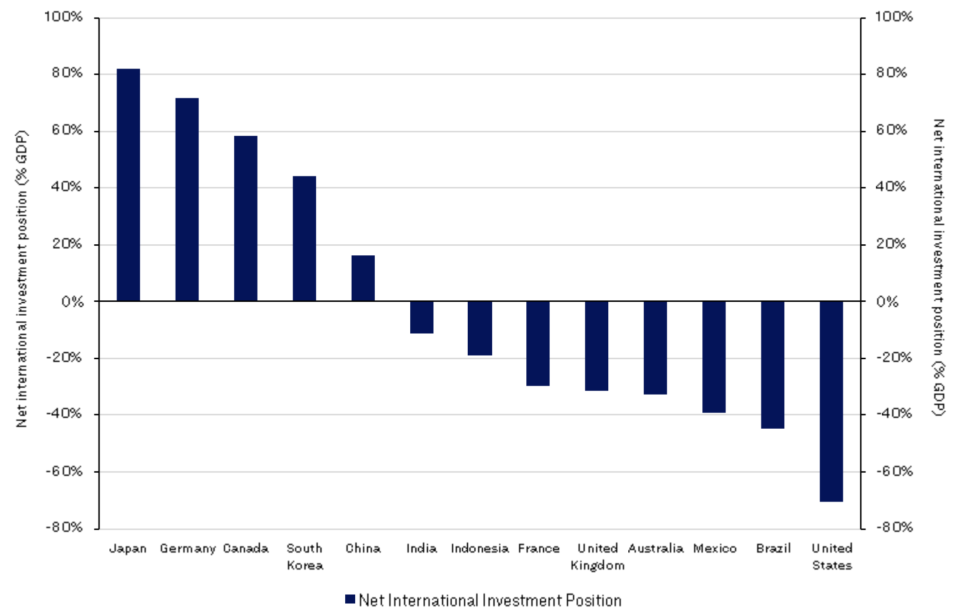
Source: United Nations, World Bank, TIAA Wealth Chief Investment Office. This chart depicts the population aged 15 years and younger and 65 years and older as a share of the working-age population (aged 15-64 years)

- The differential between the average interest rate that governments pay on their debt and the growth rate of nominal GDP is key to assessing the sustainability of fiscal spending. For example, for a country with a debt-to-GDP ratio equal to 100%, if interest rates are 2% lower than nominal GDP growth, the government can run a primary budget[3] deficit of ~2% without causing an increase in the ratio. In other words, low interest rates provide governments with more leeway to increase their spending without causing a deterioration of their finances. Given the recent sharp increase in interest rates and the concomitant normalization of nominal GDP growth, large primary budget deficits are causing a rapid rise in debt-to-GDP ratios, and investors are paying attention.

- Finally, concerns over debt sustainability are likely to be more pronounced in those countries that rely heavily on external financing to fund domestic consumption. A proxy for this is the net international investment position, or the difference between foreign assets owned by domestic investors and domestic assets owned by foreign investors (Figure 8). Countries (like France, the U.S., the UK and many emerging markets) that depend on non-domestic savings to finance budget deficits are more vulnerable than those countries (like Japan and Germany) where government debt is largely owned by private and public domestic investors (including central banks). For context, Japan has been running an average budget deficit of almost 6% since 2000, and yet its 10-year government bond has yielded less than 1% on average since then, with minimum volatility. On the other hand, in the U.S., with a much less favorable net international investment position, the yield on the U.S. 10-year Treasury has averaged 3.25% over the same period, as foreign investors (including governments and central banks) buy/sell U.S. Treasury securities.

[3] The primary budget is the difference between government revenues and government spending, excluding interest payments.

Figure 8
Net international investment position illustrates the difference between foreign assets owned by domestic investors and domestic assets owned by foreign investors.



Source: United Nations, World Bank, TIAA Wealth Chief Investment Office.

Why it Matters for Markets/Investors

Rising debt, deficits and the interest payments required to finance deficit spending pose several risks to the economy, the financial system, and the post-WWII geopolitical order. According to the CBO, "Debt that is high and rising as a percentage of GDP could slow economic growth, push up interest payments to foreign holders of U.S. debt, heighten the risk of a fiscal crisis, elevate the likelihood of less abrupt adverse effects, make the U.S. fiscal position more vulnerable to an increase in interest rates, and cause lawmakers to feel more constrained in their policy choices."[4] In general, the inability of the U.S. government to respond (using fiscal policy) to the next crisis is a chief concern for those worried about the economy, but bond holders (~23% of which are outside the U.S.) may start to punish the U.S. Treasury by demanding more protection (via higher rates) to borrow to finance deficit spending.

In addition, higher rates for Treasury securities may push up borrowing costs for corporations, and eventually crowd out some companies from borrowing to fund capital spending used to grow and modernize their businesses.[5] This, in turn, lowers productivity of the U.S. economy, and puts upward pressure on inflation, all else equal. Moreover, mounting debts and deficits erode the U.S. standing internationally and ultimately, could weigh on the reliance of the U.S. dollar as the world's reserve currency.[6] A loss of reserve status would not only weaken the dollar and push up domestic inflation, but it would also further increase future borrowing costs for the U.S. government and corporations.

That said, escalating debt and deficits do not always translate to higher borrowing costs or reduced access to borrowing for governments. For example, Japan's debt to GDP ratio stands at ~230% and has been above 100% since 1998 but Japan never lost access to the debt market and its borrowing costs are among the lowest in the world. However, it is important to note that foreign investors own only ~7% of Japanese government debt while the Bank of Japan owns ~53%, which insulates it from the global bond market to some extent. As noted above, around 23% of U.S. government debt

[4] CBO, March 2024

[5] Borrowing rates for corporations in the debt markets are largely determined by yields on Treasury notes and bonds, plus a spread to compensate borrowers for credit risk.

[6] A reserve currency is a large quantity of currency maintained by central banks and other major financial institutions to prepare for investments, transactions, and international debt obligations, or to influence their domestic exchange rate. A large percentage of commodities, such as gold and oil, are priced in the reserve currency, causing other countries to hold this currency to pay for these goods.

(bills, notes, and bonds) is held outside the U.S. Still, Japan's high domestic debt load exacerbated its economic woes and contributed to a long period of underperformance by the Japanese economy and Japanese equities markets. This negatively impacted Japan's currency and, at the margin, hurt the competitiveness of Japanese companies in the world economy.

No easy solutions for the fiscal problems, but there is still time

Current fiscal plans do not suggest a plan to tighten budgets. If interest rates do not decrease, it may further compound an increasing cost to the economy via interest rates. There are no easy fixes to the deficit issue. Some combination of less federal spending on major programs (Social Security, Medicare, and Medicaid) and more revenue (via higher taxes) will ultimately be required. However, accomplishing that is easier said than done in the current political environment. Notably, in its recent downgrade of U.S. debt, one of the major credit rating agencies noted "the repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management. In addition, the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process."[7]

However, there are examples of the two political parties in the U.S. working together to resolve fiscal challenges. Of those, the most impactful was the agreement struck in the early 1980s between Republican President Ronald Reagan and the Democratic Speaker of the House, Tip O'Neill to put Social Security on a sustainable path; Reagan allowed tax increases while O'Neill agreed to benefit cuts (raising the retirement age gradually). That type of bi-partisan approach would be necessary today to achieve any real progress legislatively.

Outside of the political realm, there also may be some hope to rein in spending in certain areas of the budget. Artificial intelligence (AI) driven innovation in delivering healthcare could have a major impact on healthcare costs, a key driver of mandatory spending like Medicaid, Medicare, and certain portions of the disability insurance component of the Social Security program.

Counterintuitively, the higher trajectory for inflation in the coming years could be a benefit. While not ideal for economic, standard-of-living, and policy reasons, rising rates of inflation lead to higher tax collection on income, payroll, and corporate taxes, and makes it easier to repay the debt issued when inflation was lower. That said, as we've all seen in recent years, elevated inflation readings have consequences for households and businesses alike.

Finally, any concerns around the sustainability of the trajectory of fiscal policy should be contextualized within the reality of many of the core strengths of the U.S. economy. In particular, we focus on the dominance of the U.S. economy (around one-fourth of global GDP), the reserve status of the U.S. dollar (which accounts for 58% of global currency reserves, ~60% of international banking claims and liabilities, and 70% of foreign currency debt issuance), and the size of capital markets (the total market capitalization of U.S. stocks amounts to more than 40% of global equities). These factors make the U.S. debt situation unique and minimize the risk of a broad exodus of foreign investors that would precipitate a fiscal reckoning.

Conclusions

The U.S. has run a deficit in all but a handful of years since the end of WWII and despite that, the U.S. economy remains the largest, most dynamic, and innovative economy in the world. While deficits, the mounting debt levels and the interest payments needed to service the debt are receiving more attention from investors today, this confluence is not yet having a meaningful or sustained impact on the U.S. economy or financial markets. Still, a resolution is needed to set the U.S. on a course toward fiscal sustainability. Some portion of the solution must come from

[7] Fitch 2023

Washington D.C. itself, and history suggests that Congress won't act until a true crisis is at hand. However, while the U.S. can't grow its way out of its fiscal woes, ongoing innovation, growing demographics, and its leading status on the world stage offer some hope for the decade ahead.

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