

Special Commentary — February 15, 2024

Should We Worry About American Debt?: Time to Reconsider?

Part IV: Federal Government Debt

Summary

- The debt of the federal government has mushroomed in recent years. The \$27 trillion of marketable U.S. government debt at present is equivalent to roughly 100% of GDP, which is its highest ratio since the end of the Second World War.
- Chronic budget deficits have led to the inexorable rise in federal government debt. Outlays have averaged about 21% of GDP over the past 50 years while revenues have averaged only 17% over that period.
- Reducing the deficit is simple, at least in theory. Lawmakers simply must raise taxes, rein in spending or some combination thereof. In reality, however, reducing the deficit is very difficult. Raising taxes is a political non-starter at present, and reining in spending involves its own challenges.
- The entitlement programs of Medicare, Medicaid and Social Security account for nearly one-half of federal spending at present, while defense spending and interest payments on the debt represent another 13% and 11%, respectively. Therefore, more than 70% of federal spending is essentially "untouchable" from a political perspective. Even if lawmakers completely zeroed out all non-defense discretionary spending, the federal government would still be incurring a deficit.
- The good news is that a debt crisis does not appear imminent. Investors continue to finance budget deficits by buying Treasury securities at reasonable interest rates. Given the depth and liquidity of the market for U.S. Treasury securities, the status of the United States as the world's largest economy and strongest military power, and the role of the U.S. dollar in the international monetary system, there simply is no substitute for Treasury bills, notes and bonds.
- But there are some costs that the rising amount of federal debt imposes. The rising debt service burden can potentially constrain other areas of federal spending, and private investment spending could potentially be "crowded out" by elevated interest rates.
- The Congressional Budget Office projects that the debt-to-GDP ratio of the federal government will rise from about 100% at present to 180% in thirty years. It is an open question whether investors will feel sanguine about the fiscal outlook for the federal government indefinitely. It is impossible to determine when a "hard stop" could occur, but an ever-rising debt burden clearly increases the probability of such an event occurring at some point in the future.

Economist(s)

Jay H. Bryson, Ph.D.

Chief Economist | Wells Fargo Economics
Jay.Bryson@wellsfargo.com | 704-410-3274

Delaney Conner

Economic Analyst | Wells Fargo Economics
Delaney.Conner@wellsfargo.com | 704-374-2150

Should We Worry About American Debt?: Time to Reconsider

[Part I: Introduction](#)

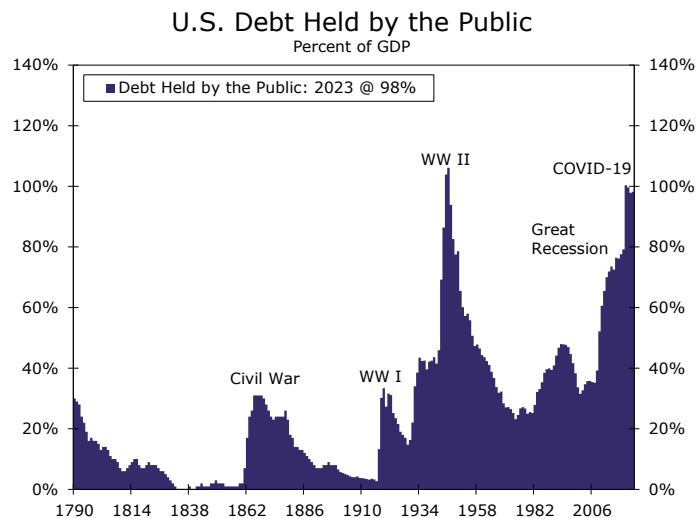
[Part II: Household Debt](#)

[Part III: Non-financial Corporate Debt](#)

Federal Government Debt-to-GDP Ratio: Highest Since End of Second World War

In the fourth installment in our five-part series on American debt, we look at the debt of the federal government. As we noted in [Part I](#) of this series, the total amount of American debt has risen by \$23 trillion since we last analyzed the topic in the summer of 2019. The federal government has accounted for 45% of this overall increase in U.S. debt. Other major categories of debt that we have addressed in this series currently stand at record highs, which is also true of the roughly \$27 trillion of outstanding debt of the federal government.¹ But unlike the household sector, where the debt-to-GDP ratio has receded considerably since 2008, the comparable ratio for the federal government has shot up significantly over the same period and currently stands near its highest level since the end of the Second World War ([Figure 1](#)).

Figure 1



Source: Congressional Budget Office and Wells Fargo Economics

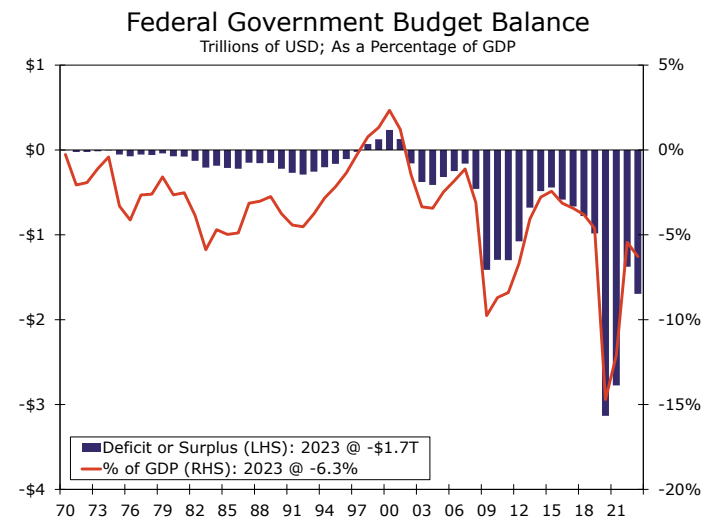
The rise in federal government debt, both in dollar terms and when measured as a percent of GDP, reflects chronic budget deficits over the past few decades. The federal government achieved a few years of budget surpluses around the turn of the 21st century ([Figure 2](#)). However, black ink quickly turned to red following the bursting of the tech bubble and the associated recession of 2001. The deficit widened further during the deep recession of 2007-2009, and it exploded during the even deeper economic downturn of 2020. The shortfall narrowed in 2021 and 2022 before widening again to roughly \$1.7 trillion (6.3% of GDP) during the fiscal year that ended on September 30, 2023. Before returning later in this report to discuss potential implications of the mushrooming amount of federal government debt, let's first discuss the underlying reasons behind its seemingly inexorable rise.

Why Can't Congress Cut Spending?

The annual outlays of the federal government have been equivalent to nearly 21% of nominal GDP, on average, since 1970 while revenues have averaged only 17.4% of nominal GDP over that period ([Figure 3](#)). At present, the outlay-to-GDP ratio is about 2 percentage points above its long-term average while the comparable ratio for revenues is a bit below its long-term average. The result is a deficit-to-GDP ratio of roughly 6% at present. We refer interested readers to a [report](#) we wrote in September that provides an in-depth analysis of the recent dynamics of the federal government's budget deficit and its near-term outlook. The important point is that outlays of the federal government have generally exceeded its revenue for more than fifty years, and the gap has grown wider in recent years. Why can't the federal government simply bring outlays in line with revenues, thereby eliminating the deficit and halting the rise in debt?

Raising taxes appears to be a political non-starter at present. But reining in spending is also politically challenging. As shown in [Figure 4](#), the entitlement programs of Social Security, Medicare and Medicaid account for nearly one-half of federal spending at present. Spending on these programs is "mandatory" in the sense that individuals automatically qualify for them after meeting certain

Figure 2



Source: Congressional Budget Office and Wells Fargo Economics

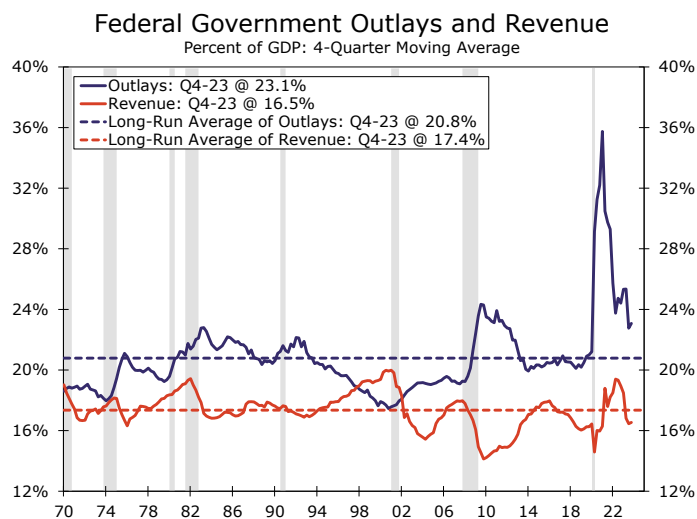
The federal government has been running chronic budget deficits.

eligibility requirements. For example, people can be enrolled in Medicare the day they turn 65. These programs are mandated by law and do not require an annual appropriation by Congress. Lawmakers could change the formulas that determine spending on these mandatory programs, but political constraints make it difficult to do so.

Defense spending represents another 13% of federal spending. Unlike the aforementioned mandatory programs, Congress must appropriate the defense budget every year. Congress could potentially cut defense spending, but many lawmakers likely would question the wisdom of deep defense cuts in today's geopolitical environment. Unless lawmakers want to default on the nation's debt, the annual interest expense on that debt, which represents another 11% of the federal budget, can't be cut. In short, more than 70% of government spending is more or less "untouchable."

Roughly 70% of government spending is more or less "untouchable."

Figure 3



Source: U.S. Department of the Treasury and Wells Fargo Economics

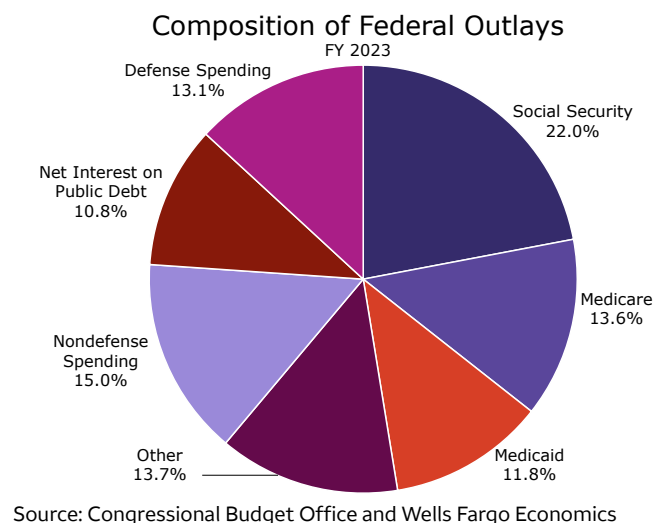
That effectively leaves less than 30% of federal spending that realistically could be cut in the current political environment. As noted previously, the federal budget deficit in FY 2023 totaled approximately \$1.7 trillion. Even if the \$917 billion of non-defense discretionary spending that the Congressional Budget Office (CBO) estimates the federal government will undertake in FY 2024 was completely zeroed out, the federal government would still run a budget deficit. In the absence of tax increases, some combination of the "untouchable" spending categories noted above would need to be pared back to eliminate the deficit completely. In theory, eliminating the budget deficit of the federal government is simple. Lawmakers need to either raise taxes or cut spending or some combination thereof. In reality, however, political constraints make it difficult to make a meaningful reduction in the federal budget deficit.

CBO makes 10-year budget projections under the assumption of no changes in current legislation. Under that assumption, CBO projects that the federal government will continue to run gaping budget deficits on the order of 5% to 6% of GDP through at least FY 2034. Moreover, the individual tax cuts that were enacted under the Tax Cuts and Jobs Act of 2017 are set to expire at the end of CY 2025. If Congress extends these tax cuts, then future budget deficits will be even larger, everything else equal. Under the assumption of unchanged legislation, CBO projects that the outstanding debt of the U.S. government will rise from its current value of roughly \$27 trillion to more than \$48 trillion in 2034. As a percent of GDP, debt will trend up from nearly 100% to 117% over that period, surpassing the high of 106% of GDP reached during World War II.

A Federal Government Debt Crisis Does Not Appear Imminent

Although these fiscal projections are quite sobering, we do not believe a debt crisis is imminent. Investors, who are undoubtedly cognizant of these projections, do not seem to be unduly concerned about the fiscal outlook for the U.S. government, at least not at the present time. For example, the U.S. Treasury Department successfully auctioned \$42 billion worth of 10-year notes on February 7—the largest auctioned amount ever of the 10-year security—at a coupon of only 4.00%. We would think that

Figure 4



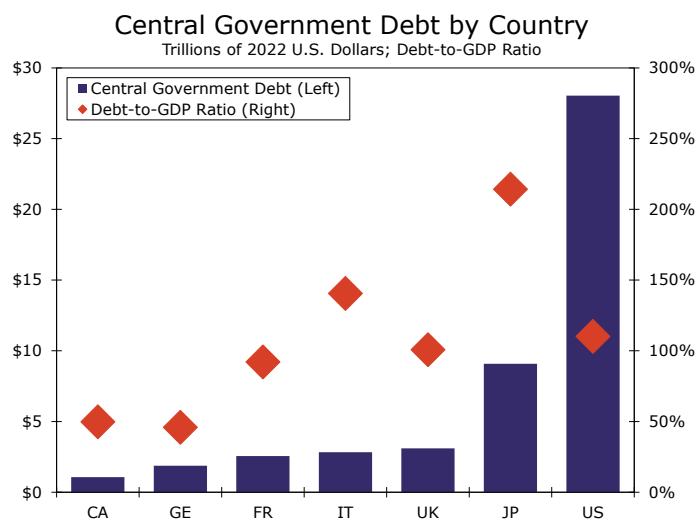
CBO projects that debt will rise from roughly 100% of GDP at present to 117% in FY 2034.

investors would demand an interest rate that was considerably higher than only 4.00% if they were really worried about the debt of the federal government over the next ten years.

Additionally, with a size of \$27 trillion, the market for U.S. Treasury securities is by far the largest bond market in the world, giving Treasury bills, notes and bonds unparalleled status in terms of market depth and liquidity (Figure 5). The Japanese government bond market is a distant second at roughly \$9 trillion. But the debt-to-GDP ratio of the Japanese government is almost double the comparable ratio for the U.S. government (red diamonds in Figure 5), and one of the major ratings agencies (Moody's) currently rates U.S. sovereign debt as triple-A while the other two (S&P and Fitch) give it a double-A rating. In contrast, all three agencies rate Japanese government bonds as single-A. Germany has a pristine triple-A sovereign debt rating from all three agencies, but the size of the German government bond market is less than 10% as large as the market for Treasury bills, notes and bonds. The United States is home to the world's largest economy and strongest military power, and the U.S. dollar remains the preeminent reserve currency. In short, there simply is not a good substitute for U.S. Treasury securities as an investable asset.

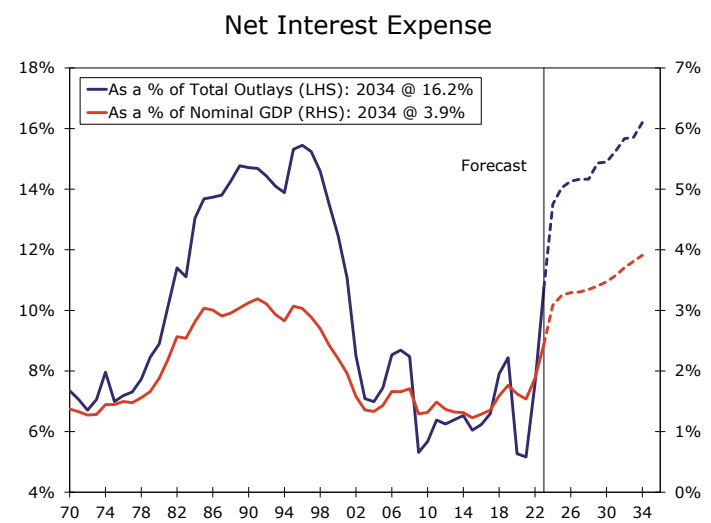
There simply is not a good substitute for U.S. Treasury securities as an investable asset.

Figure 5



Source: International Monetary Fund and Wells Fargo Economics

Figure 6



Source: Congressional Budget Office and Wells Fargo Economics

But Markets May Be Less Sanguine in the Longer Run

Although the risk of an imminent debt crisis seems low, in our view, there are some costs that the rising amount of federal debt imposes. The combination of an elevated amount of outstanding debt and the sharp rise in interest rates over the past few years is putting increasing pressure on the budget of the federal government. The low interest rate environment of the past decade caused the share of the budget that the federal government devotes to servicing its debt to nosedive (Figure 6). However, that share rose during the last two fiscal years from its lows of roughly 5% in FY 2020 and FY 2021, and CBO projects it will exceed 16% ten years from now. As a percent of GDP, CBO also projects that debt service will rise from only 2.4% in FY 2023 to nearly 4% in FY 20234. As we explained in our [September report](#), however, the debt service ratio could approach 5% of GDP ten years from now if interest rates are one percentage point higher than CBO assumes in its analysis.

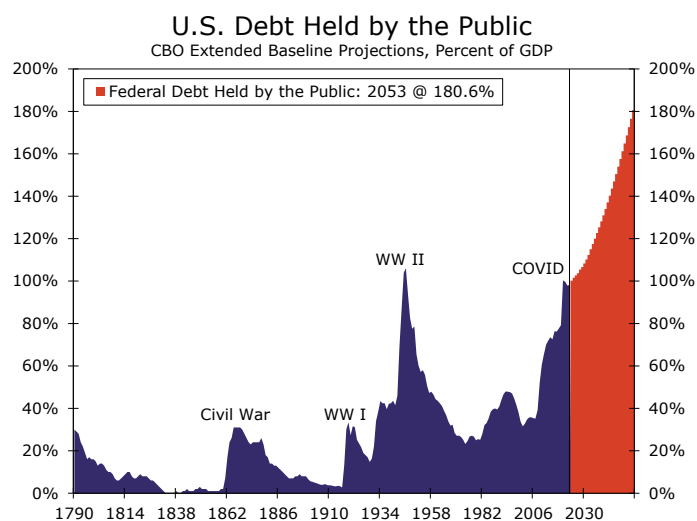
The rising debt service burden can potentially constrain other areas of federal spending, such as infrastructure, education, defense, etc. Of course, lawmakers could choose to maintain levels of spending in those discretionary programs, but then they would need to accept higher deficits if they also want to keep taxes unchanged. To the extent that rising federal debt leads to an increase in long-term interest rates, private investment spending could potentially be "crowded out," which could reduce the long-term potential growth rate of the U.S. economy. Not only does the rising amount of government debt potentially impose these opportunity costs on society, but investors may not always be so sanguine about the fiscal outlook. CBO currently projects that, under current legislation, the debt-to-GDP ratio of the federal government will rise to 180% by the early 2050s (Figure 7). CBO also projects that federal spending will grow more than 50% over the next ten years with mandatory spending and interest on the debt together accounting for roughly 90% of this increase. Will investors

Elevated government debt imposes some opportunity costs on society.

continue to finance the U.S. government at low interest rates if its debt-to-GDP ratio follows CBO's projected trajectory in coming years?

An optimist could point out that the debt-to-GDP ratio of the Japanese government has ballooned from less than 10% in the early 1970s to more than 200% at present, yet the yield on the 30-year Japanese government bond (JGB) remains comfortably below 2%. But readers should not infer that the Japanese experience necessarily has similar implications for the United States. Due to years of quantitative easing and a policy of "yield curve control," the Bank of Japan (BoJ) currently owns more than 45% of outstanding JGB's, which the BoJ is not likely to actively sell anytime soon. Consequently, the marketable amount of JGB's, which is equivalent to roughly 115% of GDP, is significantly less than the total amount of Japanese government debt. Moreover, less than 10% of Japanese government debt is held offshore, whereas foreigners presently own more than 25% of U.S. government debt. U.S. dollar-denominated debt generally exposes foreign creditors to foreign currency risk, which may make them more susceptible to sell those securities during periods of financial market volatility.

Figure 7



Source: Congressional Budget Office and Wells Fargo Economics

Conclusion

The chronic budget deficits that the federal government has incurred over the years has caused the outstanding amount of U.S. government debt to balloon to its current level of roughly \$27 trillion. As we have argued in the preceding reports in this series, the correct way to think about debt is to measure it relative to something else that tends to grow over time. But the debt-to-GDP ratio of the federal government has also mushroomed in recent years, and it currently stands at its highest level since the end of the Second World War.

Reducing the deficit, which would slow the rise in government debt, is simple, at least in theory. To reduce the deficit, lawmakers must slow the rate of growth in spending, increase the rate of growth in revenues, or some combination thereof. In reality, however, reducing the deficit is quite challenging. Tax increases are a political non-starter in today's political environment, and spending reduction is also politically difficult because more than 70% of federal spending is deemed to be "untouchable." CBO projects that the federal government will continue to incur gaping budget deficits over the next ten years, which will cause the debt-to-GDP ratio to trend even higher.

The good news is that a crisis does not appear imminent. About 11% of the federal government's budget was devoted to servicing debt in the fiscal year that ended on September 30, which is below the ratios of the mid-1990s. The generally low level of yields on longer-dated Treasury notes and bonds indicates that investors do not seem to be unduly concerned about the fiscal outlook for the U.S. government, at least not at this time. The market for U.S. Treasury securities is the deepest and most liquid financial market in the world. The status of the U.S. dollar as the world's principal reserve currency and the position of the United States as the world's largest economy and most militarily

powerful nation also enhance the appeal of U.S. Treasury securities. In our view, investors will continue to finance the budget deficits of the U.S. government for the foreseeable future.

But CBO currently projects that the debt-to-GDP ratio of the federal government will nearly double over the next thirty years, and it is an open question whether investors will continue to feel so sanguine about the fiscal outlook for the federal government indefinitely. Investors could eventually demand higher interest rates to hold the significantly larger stock of Treasury securities, which would increase the cost of servicing that debt. Herbert Stein, who was Chair of the Council of Economic Advisers under Presidents Nixon and Ford, famously said "If something cannot go on forever, it will stop." Stein's axiom could eventually apply to U.S. government debt. The mechanism by which the inexorable rise in government debt is brought to an end could be the refusal of investors to finance continued deficits. It is impossible to determine when that "hard stop" could occur, but an ever-rising debt burden clearly increases the probability of such an event occurring at some point in the future.

Endnotes

1 - Federal government debt that is held by the public currently totals nearly \$27 trillion. When intragovernmental debt, such as the Social Security Trust Fund, is included, the total rises to nearly \$34 trillion. ([Return](#))

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| | | | |
|----------------------|--------------------------|--------------|-------------------------------------|
| Jay H. Bryson, Ph.D. | Chief Economist | 704-410-3274 | Jay.Bryson@wellsfargo.com |
| Sam Bullard | Senior Economist | 704-410-3280 | Sam.Bullard@wellsfargo.com |
| Nick Bennenbroek | International Economist | 212-214-5636 | Nicholas.Bennenbroek@wellsfargo.com |
| Tim Quinlan | Senior Economist | 704-410-3283 | Tim.Quinlan@wellsfargo.com |
| Sarah House | Senior Economist | 704-410-3282 | Sarah.House@wellsfargo.com |
| Azhar Iqbal | Econometrician | 212-214-2029 | Azhar.Iqbal@wellsfargo.com |
| Charlie Dougherty | Senior Economist | 212-214-8984 | Charles.Dougherty@wellsfargo.com |
| Michael Pugliese | Senior Economist | 212-214-5058 | Michael.D.Pugliese@wellsfargo.com |
| Brendan McKenna | International Economist | 212-214-5637 | Brendan.Mckenna@wellsfargo.com |
| Jackie Benson | Economist | 704-410-4468 | Jackie.Benson@wellsfargo.com |
| Shannon Grein | Economist | 704-410-0369 | Shannon.Grein@wellsfargo.com |
| Nicole Cervi | Economist | 704-410-3059 | Nicole.Cervi@wellsfargo.com |
| Patrick Barley | Economic Analyst | 704-410-1232 | Patrick.Barley@wellsfargo.com |
| Jeremiah Kohl | Economic Analyst | 704-410-1437 | Jeremiah.J.Kohl@wellsfargo.com |
| Aubrey George | Economic Analyst | 704-410-2911 | Aubrey.B.George@wellsfargo.com |
| Delaney Conner | Economic Analyst | 704-374-2150 | Delaney.Conner@wellsfargo.com |
| Anna Stein | Economic Analyst | 212-214-1063 | Anna.H.Stein@wellsfargo.com |
| Coren Burton | Administrative Assistant | 704-410-6010 | Coren.Burton@wellsfargo.com |

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