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A Case for Federal Deficit Reduction

Spending Cuts to Avoid a Fiscal Crisis

By Ryan Bourne

EXECUTIVE SUMMARY

The United States is heading for a fiscal crisis, sooner or later, if it does not reduce its federal budget deficit to curb the growth of debt. Federal budget deficits are already high and set to rise further. This will add to the federal debt, which within four years will hit its highest-ever level relative to GDP. On unchanged policies, age-related entitlement spending will then increase debt much further over the next three decades. Meanwhile, higher interest rates after the recent inflation have raised the cost of new government borrowing and of managing existing debt as it matures.

While there is substantial uncertainty regarding the future path of interest rates and when, precisely, a fiscal crisis might occur, there is a strong case for taking action today to avert the possibility down the road. A deficit reduction program implemented today would not only provide insurance against a fiscal crisis or reduce the prospects of debt weighing on economic growth, but it would also avoid the clear pitfalls of developing policy in the heat of a crisis.

In an ideal world, a deficit reduction package would entail forward-looking reforms to age-related entitlement programs, elimination of wasteful or economically harmful government programs, and pro-growth tax and regulatory reforms to ease the burden of the fiscal adjustment. Unfortunately, such a comprehensive package looks politically unlikely any time soon. At the very least, policymakers should work to identify spending cuts that make economic sense or to develop a fiscal resolution plan (or “living will”) that could form the basis of negotiations for deficit reduction should a crisis occur.

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INTRODUCTION

We could call it a warning. For years, politicians in Washington, DC, have been running up the federal debt, not least through borrowing vast amounts for bailouts and stimulus packages during crises. Between 2007 and 2022, federal debt held by the public surged from $4.6 trillion to $24.3 trillion. That propelled debt from just 36 percent relative to gross domestic product (GDP) to 96 percent, the highest level since World War II.[1]

For most of that period, mainstream economists told politicians they could be relatively relaxed about this flow of red ink. The sharp jumps in debt hadn't produced obvious ill effects for the macroeconomy, nor had they apparently generated angst among the federal government's lenders. Even by 2018, the debt was an "absolutely trivial" worry, according to Nobel Prize–winning economist Paul Krugman, not least because of low interest rates.[2] In a January 2019 *Foreign Affairs* article, former Treasury secretary Larry Summers and former chair of President Obama's Council of Economic Advisers Jason Furman wrote that, with extensive global savings and "suppressed investment demand," interest rates would remain historically low.[3] This would reduce the costs of financing a growing government debt, raising the burden of debt the country could bear sustainably.

In his 2019 American Economic Association presidential address, Olivier Blanchard, former chief economist of the International Monetary Fund, spoke to the growing consensus for less concern about rising debt, saying, "The signal sent by low rates is not only that debt may not have a substantial fiscal cost, but also that it may have limited welfare costs."[4] Debt was near enough a free lunch. Sure, politicians would eventually need to reform unsustainable old-age entitlement programs or raise taxes significantly to fund those promises to seniors—but that was a distant problem.

Politicians obliged. Running increasingly large budget deficits became the norm, even in "normal" times. Annual borrowing was running at 4.6 percent of GDP before the pandemic—the largest gap between spending and tax revenues since the mid-1980s—despite historically low unemployment. Congressional pandemic spending packages and a downturn in revenues added a further $7.5 trillion in debt from 2019 to 2022.

Then inflation hit. As the Federal Reserve tightened monetary policy to choke off rising prices, Treasury yields—the interest rates the federal government pays to those who lend it money—saw their sharpest rise since Paul Volcker's monetary tightening from 1979 to 1982.[5] The yield on a 10-year Treasury peaked at 5 percent on October 23, 2023, before receding to just under 4.2 percent by March 2024.[6] That's still 75 percent higher than the average yield seen through the second half of the 2010s.[7]

> "The longer that higher yields endure, the worse the implications for the federal government's budget deficit."

A core assumption behind the blasé attitude to debt—that interest rates would remain low—had evaporated. While it's unclear whether higher yields are a temporary blip or the herald of sustained higher rates, analysts realized that the US debt outlook is highly sensitive to the path of these uncertain borrowing costs. Sustained low rates could no longer be taken for granted. The ratings agency Fitch downgraded US debt. The term premium on debt rose in the fall of 2023. Commentators and economists, including the previously relaxed Blanchard, now openly worry about a full-blown US fiscal crisis.[8]

The jump in yields has already made it more costly for the government to borrow, at a time when Congress plans to borrow an average of $2 trillion per year over the next decade.[9] Higher yields are also making the government's outstanding $27.5 trillion debt pricier to manage, as existing debt must be refinanced at higher rates as securities mature.[10] The longer that higher yields endure, the worse the implications for the federal government's budget deficit and the future path of debt.

For all the focus on bond yields, however, the truth is that the United States was on an unsustainable fiscal path even before rates spiked and will remain so even if yields fall back again. Some basic fiscal truths show that we are headed toward a fiscal crisis, sooner or later, unless significant action is taken to reduce the scale of future deficits and debt. Higher bond yields merely accelerate this timeline. The events of the past 12 months have been a flashing warning signal of the general need to get our fiscal house in order by reducing future budget deficits.

FIVE FISCAL TRUTHS

It's worth taking stock of the federal government's overall fiscal position. Five basic truths indicate why a focus on mitigating future debt increases through deficit reduction is needed.

1. The United States Today Has a Historically High Budget Deficit

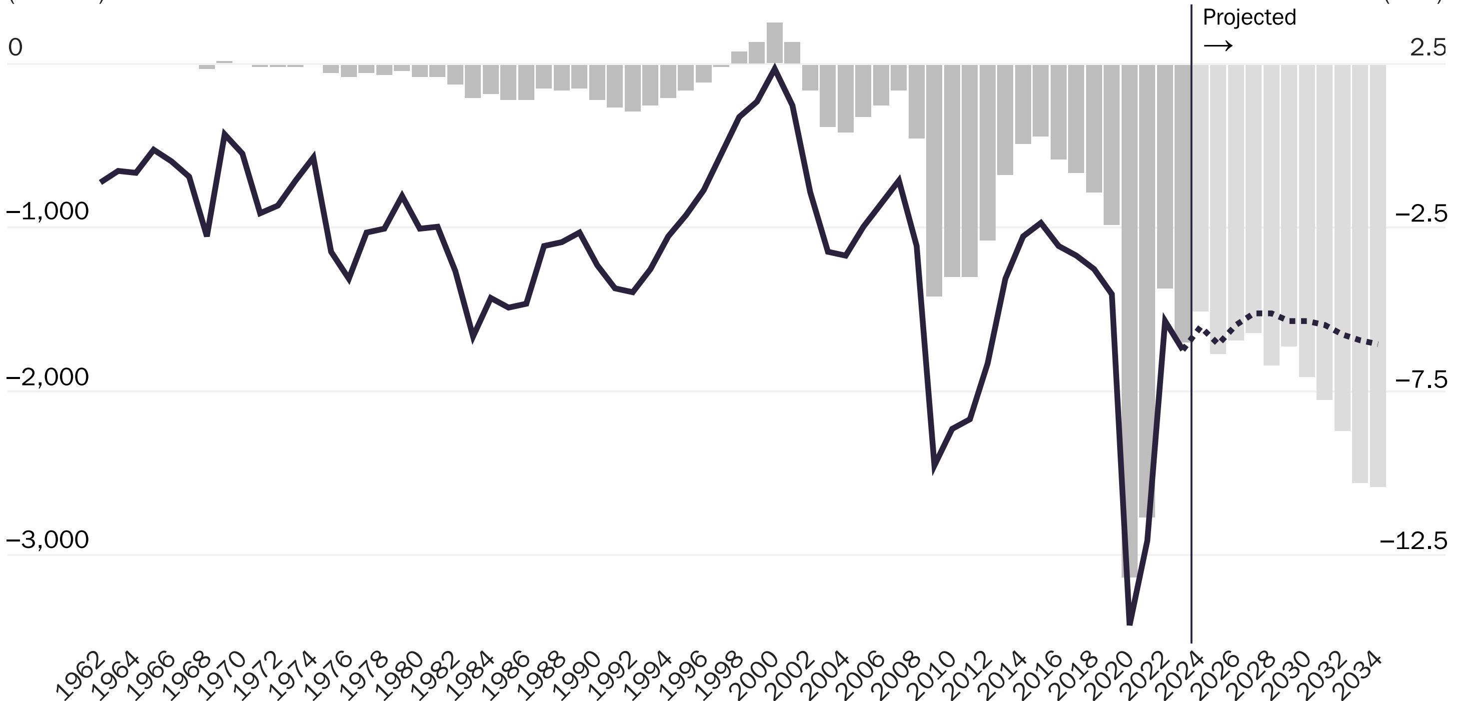
Figure 1 maps the shortfall of revenues relative to government spending (i.e., the federal budget deficit), both in dollar terms and as a percentage of GDP, since 1962. In the past, recessions led to big increases in deficits, which then eroded as the economy recovered. More recently, deficits have been growing and were very high going into the pandemic, even after more than a decade without a recession.

Figure 1 also illustrates the Congressional Budget Office (CBO)'s March 2024 budget deficit projections for the next 10 years. It estimates, on current policy, that annual deficits will grow to $2.6 trillion per year by 2034. The recorded deficit from 2023, at $1.7 trillion (or 6.3 percent of GDP), was 23 percent higher than in 2022, but even that was pushed artificially downward by the CBO recording the Supreme Court's cancellation of Biden's student loan forgiveness plan as a one-off spending cut.[11] The real underlying figure was around $2 trillion, or 7.4 percent of GDP. This is easily the largest deficit recorded outside of wars or acute emergencies, not just since the 1960s, which saw the escalation of the Vietnam War and the launching of the Great Society programs, but since the Great Depression of the 1930s.

Worryingly, even the projections for ballooning deficits in the next decade understate the scale of red ink. They assume that large portions of the Tax Cuts and Jobs Act will be allowed to simply expire, that no other large spending programs will be introduced after the next presidential election, and that no unexpected shocks or recessions will hit in the interim. And recent congressional legislation has also added significant uncertainty over borrowing. The CBO's latest projections increased the estimated cost of the Inflation Reduction Act and other energy-related tax provisions by $428 billion over the

Figure 1

Federal budget balance is historically high and rising



Sources: "10-Year Budget Projections," Budget and Economic Data, Congressional Budget Office, February 2024; and "Historical Budget Data," Budget and Economic Data, Congressional Budget Office, March 2024.
Note: GDP = gross domestic product.

next decade. Policies with uncapped cost implications create an uncertain path for borrowing and short-term interest rates.

2. High Deficits Come on Top of a High Existing Debt Burden

The projected flow of borrowing adds to an already high level of accumulated debt, which has jumped significantly because of the Great Recession and the COVID-19 pandemic (Figure 2). Back in 2007, federal debt was projected to fall to around 20 percent of GDP by 2017. It turned out to be almost four times that, at over 76 percent, mainly due to the financial crisis and then a tardy economic recovery. Since then, federal debt held by the public has jumped again because of pandemic borrowing and ongoing large structural deficits. By 2022, debt hit 96 percent of GDP—the highest level since the aftermath of World War II. This time there is no prospect of a sharp demilitarization that would slash spending, as occurred after World War II, and no shared political commitment to balanced budgets that might facilitate debt falling again quickly, as occurred after the 1940s.[12] In fact, debt is projected to hit its highest-ever level, 106 percent of GDP, by 2028.

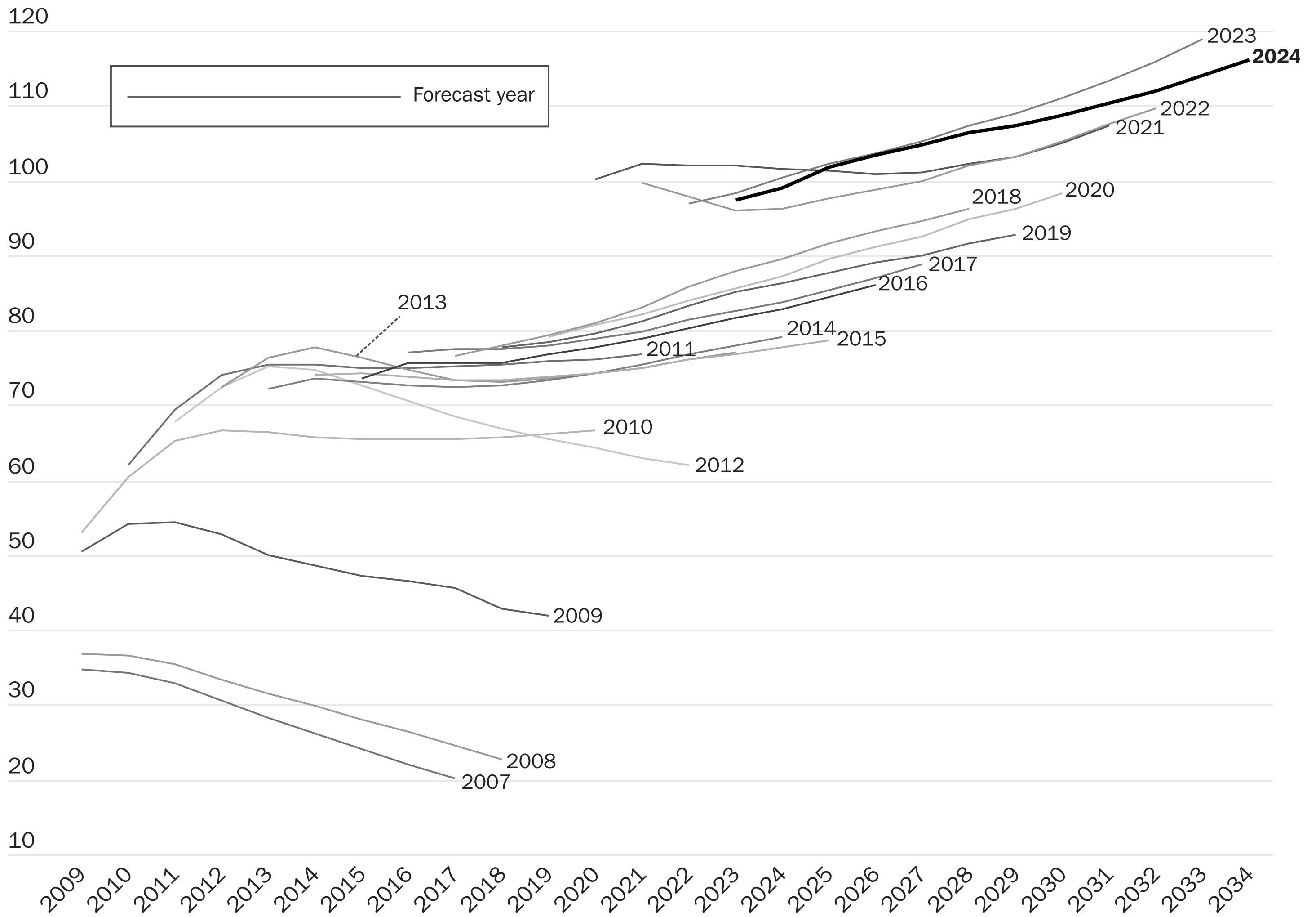
3. On Unchanged Policies, Debt Is Set to Explode Further

Which brings us to the third truth: debt in the longer term is expected to trend sharply higher, owing overwhelmingly

Figure 2

Federal debt held by the public jumped after the Great Recession and pandemic

CBO 10-year projections of debt held by the public as a percentage of GDP 2009–2024, fiscal years



Sources: Jagadeesh Gokhale and Kent Smetters, "When Does Federal Debt Reach Unsustainable Levels?," Penn Wharton Budget Model, University of Pennsylvania, October 6, 2023; and "Long-Term Budget Projections," Budget and Economic Data, Congressional Budget Office, March 2024.

Notes: CBO = Congressional Budget Office; GDP = gross domestic product.

to Social Security and Medicare promises interacting with an aging population.

The CBO regularly projects the path of debt over the next three decades on unchanged policies. Using its relatively sanguine forecasts about interest rates and future economic growth and presuming that the 2017 tax cuts are allowed to expire while no new major spending programs are introduced, Figure 3 shows that the level of debt will surge much higher, to 166 percent of GDP by 2054.[13]

This would be unprecedented. Almost all budget analysts recognize that a continuation of current policy over that timeframe, without any major offsetting adjustment through raising tax revenues or cutting spending, is not an option. In February 2020, shortly before becoming Secretary of the Treasury, Janet Yellen said that "the US debt path is completely unsustainable under current tax and spending plans."[14] The starting point since then has worsened. Indeed, those who try to model the US economy's growth prospects are usually forced to just *assume* that politicians will deliver substantive deficit reduction in the medium term to avoid this scenario, or else their models simply crash.[15]

4. Borrowing Has Become More Expensive with Higher Interest Rates

This current and prospective fiscal pressure has been worsened by rising interest rates, and it's unclear whether or how far they will fall again. In April 2020, the 10-year Treasury yield was just 0.7 percent. Now it is 4.2 percent, after not rising above 3.1 percent in the 10 years before 2022 (Figure 4).[16] Yields have risen in real (inflation-adjusted) terms too. Expected inflation can be calculated by examining the difference in yields between bonds that are protected against inflation and those that aren't.[17] As Figure 4 shows, there's been a noticeable uptick in yields relative to this measure of expected inflation. The real yield on March 20, 2024, was 1.9 percent, which, before September 2023, would have been their highest level since 2008.

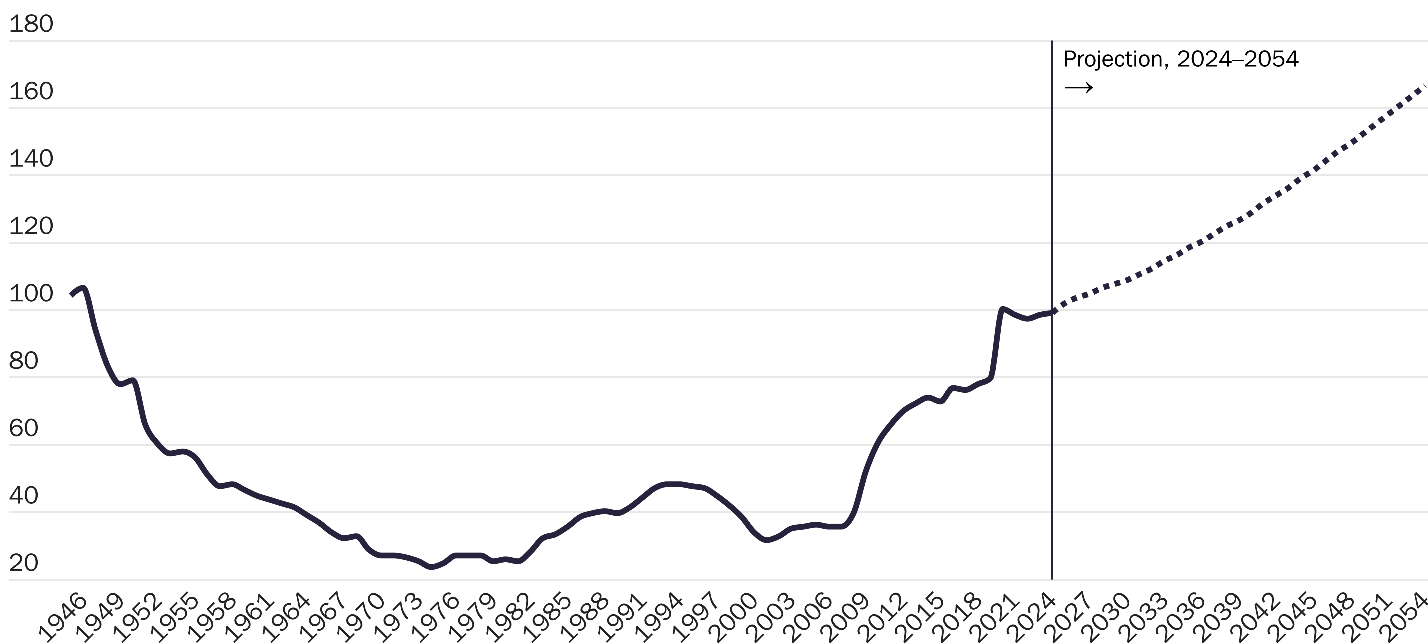
The same pattern of rising yields has occurred for Treasuries of other durations, as shown in Figure 5, which charts 2-, 3-, 5-, 7-, and 10-year yields. Quite simply, it has become more costly for the federal government to borrow.

Higher yields have two major effects on the federal finances. First, they make it more expensive for the federal government to issue new debt. This is a problem, given the federal government's large borrowing intentions.

Figure 3

On unchanged policies, federal debt held by the public will continue to soar through 2054

Actual and projected federal debt held by the public as a percentage of GDP, percent

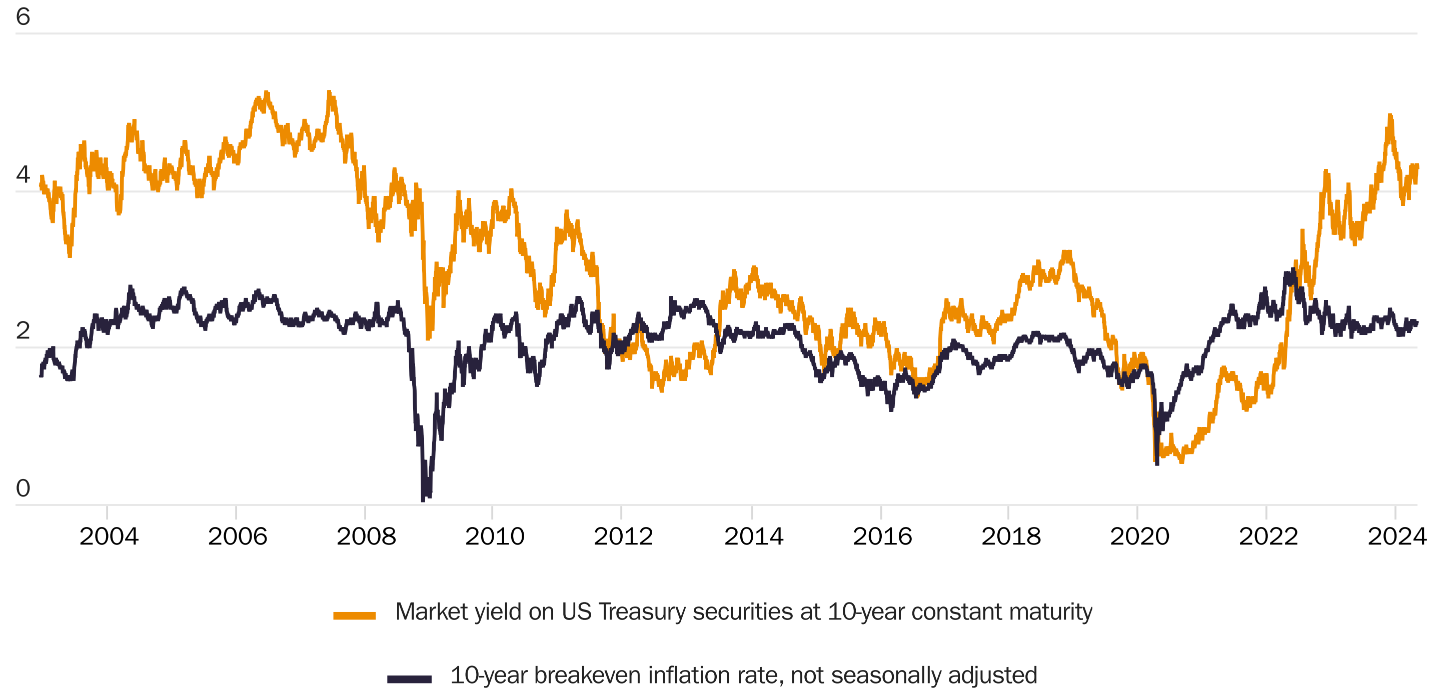


Sources: "Long-Term Budget Projections," Budget and Economic Data, Congressional Budget Office, March 2024; and "Historical Tables," Office of Management and Budget.
Note: GDP = gross domestic product.

Figure 4

Bond yields are back to levels not seen since before 2008

Market 10-year federal bond yield and 10-year breakeven inflation rate, percent

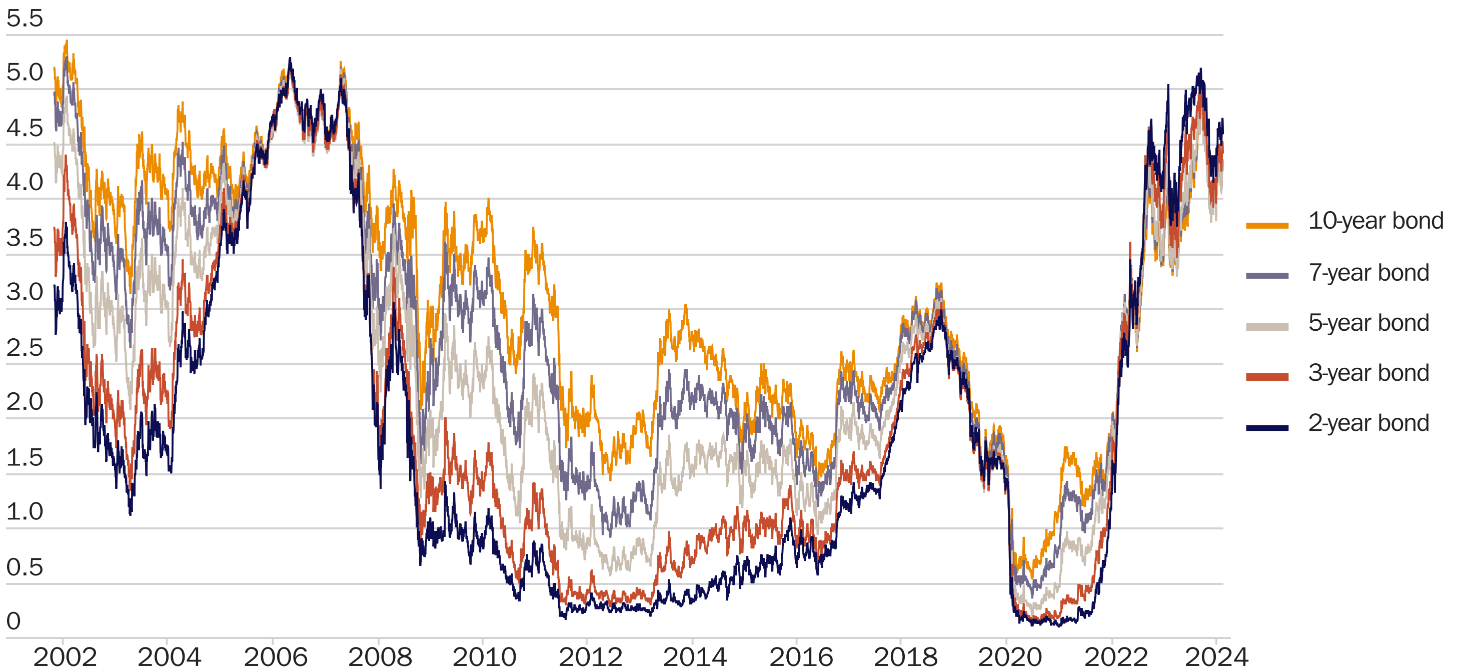


Sources: “10-Year Breakeven Inflation Rate,” Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, updated March 22, 2024; and “Market Yield on US Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis,” Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, updated March 22, 2024.

Figure 5

Yields on Treasuries across all maturity durations have surged

Bond yields, percent



Source: “Federal Reserve Economic Data,” Federal Reserve Bank of St. Louis.

The CBO now estimates that net interest payments will exceed spending on defense in 2024 and will be more than 36 percent higher within a decade.

Second, and more subtly, higher yields make existing debt more expensive, because when Treasuries mature, the debt must be refinanced if it has not been paid off. The Committee for a Responsible Federal Budget (CRFB) has calculated that $21 trillion of outstanding debt was borrowed when 10-year yields were less than 4 percent. They calculated that more than half of the $26.2 trillion outstanding debt held by the public at the end of 2023 was due to be refinanced within the next three years.[18] Given that the vast bulk of this will likely be refinanced at higher rates than that of the debt originally issued, the interest expense on debts the federal government has accumulated in the past will jump too. "Cheap" borrowing undertaken in the 2010s risks becoming increasingly expensive.

5. The Debt Outlook Is Highly Sensitive to Rising Interest Rates

Higher interest rates significantly worsen the longer-term outlook for the federal finances. We don't yet know whether we now live in a world of permanently higher interest rates or whether the apparent structural forces that pulled interest rates lower in the 2010s will reassert themselves. What we do know is that deficits and debt are highly sensitive to interest rate changes over the medium term. The higher that bond yields remain, and the longer that higher rates endure, the worse the prospects for the federal government's finances.

A Congressional Budget Office tool published in 2023 highlighted how sensitive overall borrowing is to yield rises (Figure 6).[19] If all interest rates through 2033 were to remain 0.5 percentage points higher than the CBO had projected in February 2023 (equivalent to a 10-year Treasury yield of 4.3 percent rather than 3.8 percent for most of that period), federal borrowing would increase by $1.5 trillion over the next decade, raising annual debt interest payments by 0.6 percent of GDP by 2033.

Over the longer term, the impact of higher interest rates is more striking. Manhattan Institute federal budget expert Brian Riedl projected in 2023 that long-term interest rates gradually increasing to 1 percentage point higher than expected by 2053 (so, 5 percent for a 10-year Treasury then, rather than 4 percent) would lead to net interest costs equivalent to 10.4 percent of GDP by that time.[20] That's significantly higher than the otherwise-projected 6.7 percent.

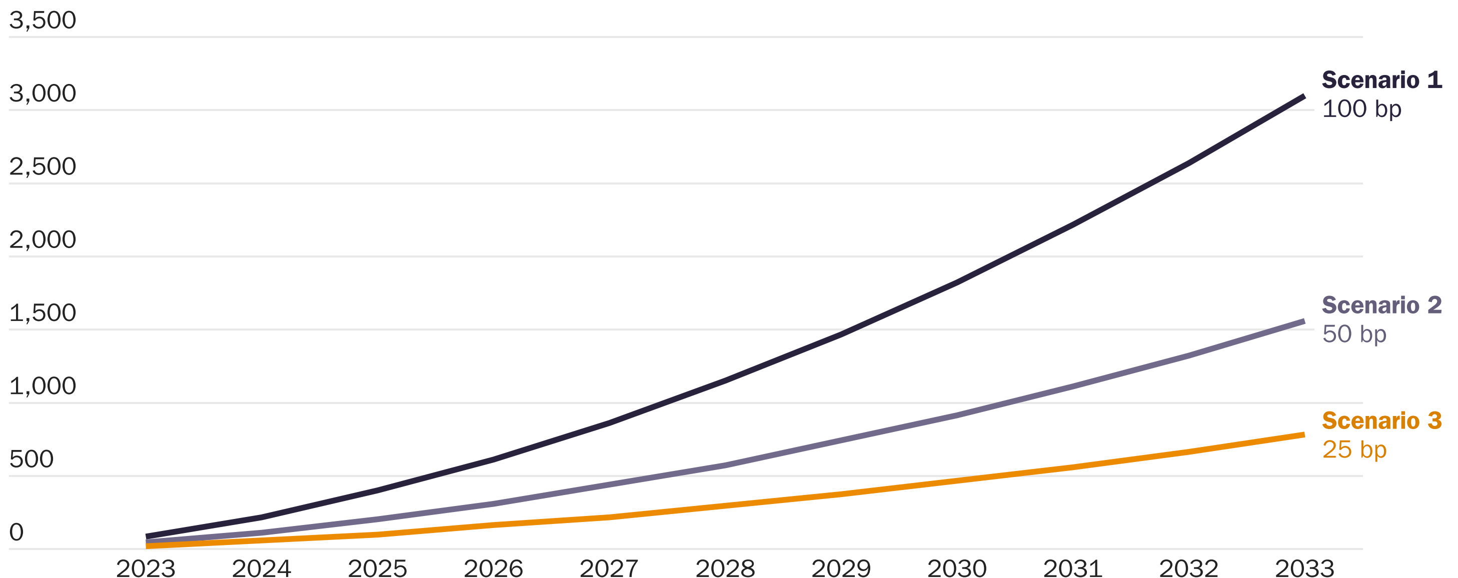
THE CASE FOR DEFICIT REDUCTION

Some might look at these fiscal truths and think it obvious that prudence demands efforts to reduce budget deficits

Figure 6

Government borrowing is sensitive to higher interest rates

Additional cumulative government borrowing under different interest rate scenarios, billions of dollars



Source: Dan Ready et al., "How Changes in Economic Conditions Might Affect the Federal Budget: 2023 to 2033," Congressional Budget Office, April 2023.

and lower this debt path. But what is the economic problem with high and rising debt? What's the real benefit of actively working to shrink deficits and curb the future debt path? There are three big-picture economic justifications for why deficit reduction is both urgent and desirable.

1. As Insurance against an Acute Fiscal Crisis

One rationale for reducing deficits today would be to reduce the risk of an acute fiscal crisis, which could cause financial and economic chaos. If investors were to lose confidence in the federal government's ability to repay its debts, they would demand sharply higher interest rates to lend it money or even stop lending altogether. This could lead to a devastating financial crunch, given that the government relies heavily on borrowing to finance its ongoing operations.

A sharp, large surge in bond yields would feed directly into a higher deficit, with extra borrowing then driving up yields further in a so-called fiscal doom loop. Eroding investor confidence, heightened macroeconomic uncertainty, and a growing sense that the government might eventually lean on the Federal Reserve to print new money to fund the government (risking higher inflation) would result in steep declines in the dollar as money flees from dollar-denominated assets.[21] Higher interest rates would squeeze private sector investment and would cause financial turmoil by wreaking unexpected havoc with asset values. The federal government would find it very difficult to finance its core obligations, and the only way to avoid leaning on the Fed to print money would entail rapidly closing deficits with deep austerity cuts to government spending, large tax increases, or both.

A fiscal crisis thus inevitably ends with some combination of a default, sharp and painful austerity, or high inflation. Politicians are always in the market for votes, so we can expect them to—striking a populist pose—try to saddle wealthy creditors with shouldering much of the cost of deficit reduction and try to insulate people dependent on government programs from any spending cuts. That's why it would be tempting to formally default on outstanding debt, or to have the Fed "monetize" some of it, creating new money to buy US Treasuries directly or indirectly from the market, thus effectively financing the government's deficit by increasing the money supply. This would produce a sudden burst of unexpected inflation that transfers wealth from Treasury note holders to those who benefit from government spending. But even such monetization offers only a temporary reprieve. Investors would demand higher interest rates if they expected higher inflation.

> "Fiscal crises are inherently unpredictable. Greece was able to borrow relatively cheaply until suddenly it wasn't."

Mercifully, markets have not yet concluded that the US federal government is insolvent and that such drastic measures are likely. Bond yields remain elevated and debt auctions have seen weaker demand for government debt, forcing the government to pay higher rates to borrow.[22] But yields are not surging to the sorts of extreme levels they did in Greece (up to 29 percent) during that country's fiscal crisis that began in late 2009.[23] Nor indeed, as Figure 1 showed, do we see higher inflation expectations that would signify investors expect the Federal Reserve to start monetizing debt.

The problem, though, is that fiscal crises are inherently unpredictable. Greece was able to borrow relatively cheaply until suddenly it wasn't (Figure 7). There, the trigger for the crisis was the newly elected government's revelation that in 2009 the country was running a mammoth deficit of almost 12.5 percent of GDP, much higher than the previous government had estimated.[24] That shifted perceptions about the country's fiscal sustainability and creditworthiness, leading to its 10-year bond yield jumping from 6.5 percent to 29.2 percent within two years. This was a precursor to a severe dose of enforced austerity alongside three international bailouts.

The fiscal situation in the United States is not like the one in Greece. Our bookkeeping is more honest and with a sovereign central bank, the country can always meet its nominal debt obligations in its own currency by printing money (though relying on the Fed to acquiesce would undermine central bank independence). But we do have bad debt dynamics and

a political class seemingly unbothered by the flow of red ink. That brings with it a risk of changing investor sentiment.

Fitch downgraded US debt from AAA to AA+ in August 2023, citing an anticipated "fiscal deterioration," escalating "general government debt burden," and "the erosion of governance" (read: fiscal irresponsibility). Since then, the federal deficit has risen further and Congress has had a government-shutdown standoff. Meanwhile, the unbridled escalation of debt to come due to Social Security and Medicare expenditures has not been much featured in the presidential election discourse, in which the likely two major candidates—President Biden and former president Donald Trump—have both shown a penchant for high borrowing while in office. Unlike most Organisation for Economic Co-operation and Development countries, the United States has no medium-term fiscal rules in place for the deficit or debt to shape ongoing budgeting decisions. Moody's explained its own decision to downgrade the outlook for US debt by saying that "continued political polarization in Congress raises the risk that lawmakers will not be able to reach consensus on a fiscal plan to slow the decline in debt affordability."[25]

What's more, on unchanged policies, some form of default is inevitable at some stage. Penn Wharton modelers estimate that the United States has two decades to stabilize the national debt relative to GDP.[26] After this, no combination of tax hikes or spending cuts can prevent a formal default or an implicit default (i.e., with the Federal Reserve monetizing debt by creating new money to buy government bonds). Higher borrowing costs, of course, bring this date forward. And such a default would have profound consequences. A recent working paper by economists Jason Choi, Duong Q. Dang, Rishabh Kirpalani, and Diego J. Perez has estimated that the "exorbitant privilege the US holds in global safe asset markets" significantly increases the capacity for the country to take on new debt.[27]

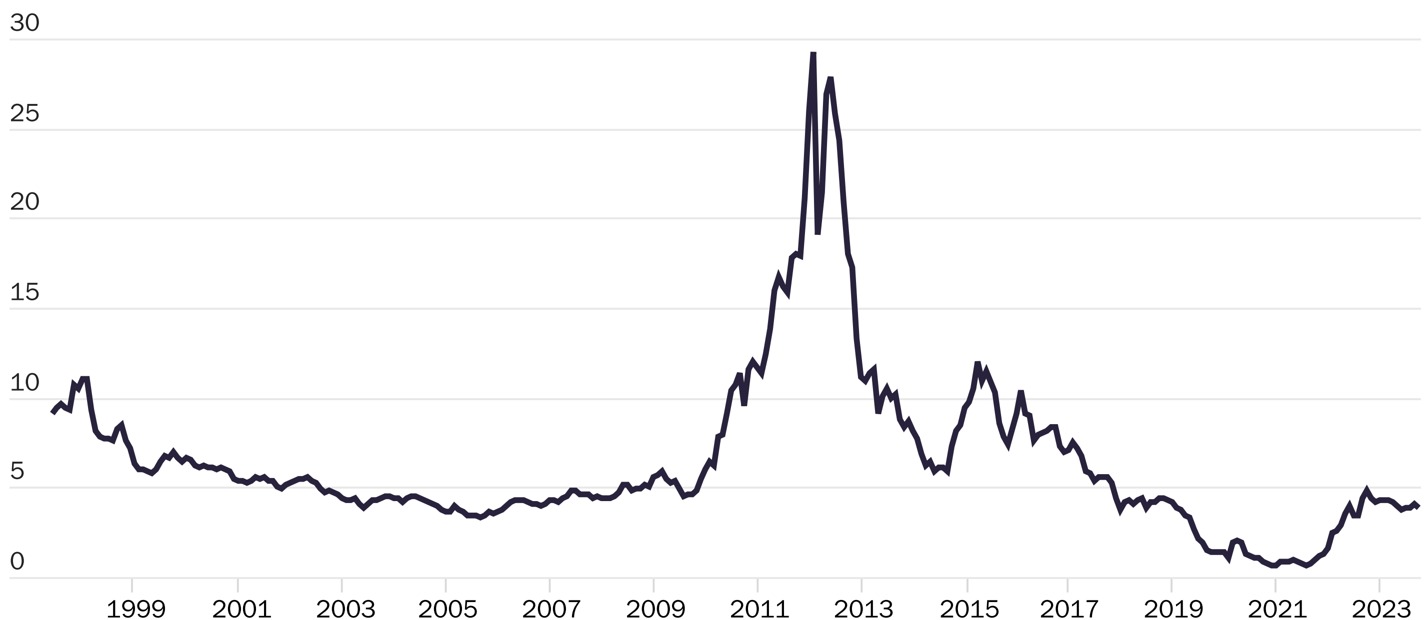
A fiscal crisis is therefore a meaningful risk and one to which policymakers pay insufficient heed. All that is really needed for it is a trigger. A war, another pandemic, a financial crisis, or a major recession could precipitate another huge wave of debt, prompting investors to fundamentally reassess their prospects of being repaid.

My colleague Romina Boccia has written persuasively that, given the US Treasury market has been regarded as a "safe haven" and the dollar has global reserve-currency status, interest rates might not even provide a gradual warning about changing sentiment.[28] The risks are also potentially greater that a fiscal crisis in the United States

Figure 7

In Greece's fiscal crisis, the 10-year bond yield jumped suddenly

Greek 10-year government bond yield, percent



Source: "Interest Rates: Long-Term Government Bond Yields: 10-Year: Main (including Benchmark) for Greece," Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, updated January 12, 2024.

could precipitate a national or international banking crisis and a so-called sudden stop, where the United States experiences a rapid reversal of capital flows. Sovereign debt crises, as economist Arnold Kling has written, seem unlikely until they happen after investor confidence shifts:

> Investors constantly evaluate a country in light of its indebtedness, history, and political condition. In a high-confidence regime, most investors conclude that repayment of debt is highly likely, so interest rates are low. In a low-confidence regime, investors concluded that repayment of debt is somewhat doubtful, so interest rates are high unless the government takes clear, drastic steps to reduce its deficit.
>
> A debt crisis can be thought of as a sudden transition from the high-confidence regime to the low-confidence regime . . . the shift is discontinuous, not a gradual smooth shift.[29]

There was a period in 2023 when the 10-year Treasury yield jumped from 3.3 percent to 5 percent within six months. Was this the first rumblings of an impending fiscal crisis? Not yet. This time, yields fell back somewhat from these peaks. But the unexpected spike was a warning about how fickle economic forecasts can be and the inherent risks of a high and rising debt burden. A sensible, enduring deficit reduction can be justified as an insurance policy against this risk of a fiscal crisis.

2. As Insurance against Bad Policy Stemming from a Fiscal Crisis

Another reason to undertake deficit reduction now, rather than wait until a crisis arrives, is that policymaking during emergencies can be extremely destructive. If we were to experience an acute fiscal crisis, it seems highly likely that politicians would panic and reach for measures like wealth expropriation to ease the inevitable cocktail of defaults, rapid deficit reduction, and higher inflation. That erosion of property rights would undermine people's willingness to save and invest in the United States.

Emergencies can lead to extraordinarily damaging public policies, many of which endure long after the emergency is over. Consider, for example, the Great Depression (with extensive industrial policy and price and entry regulations); the Great Recession (which exacerbated the demand for government bailouts during downturns); and the reaction to the COVID-19 pandemic (where all sorts of unevidenced social restrictions were imposed).

> "When forced to make swift deficit reduction decisions, governments can be shortsighted, reaching for quick fixes such as tax increases."

Even if such extreme reactions are avoided regarding broader economic policy, fiscal crises usually necessitate sharp changes in government spending and taxation if investors demand much higher interest rates to lend. When forced to make swift deficit reduction decisions, governments can be shortsighted, reaching for quick fixes such as tax increases, which can help shore up the budget in the short term but which carry long-term costs by reducing economic growth prospects. Many European countries increased value-added-tax rates and capital taxes in the aftermath of the financial crisis.[30]

The same is true, but to a lesser extent, when canceling infrastructure projects or squeezing funding for essential government functions such as the legal system that underpin prosperity. In the UK's 2010s emergency deficit reduction plan, for example, tax hikes and investment cuts (which are more damaging to economic growth) were front-loaded; funding cuts to day-to-day public services such as the police and courts came later. A lot of the most economically harmful spending on age-related welfare-state programs and fiscal transfers was entirely protected from "austerity."[31]

The problem is that savings made on the police and criminal justice system were eventually seen as false economies, leading to a rebound in spending. A political consensus developed in the 2010s that the government needed to invest more too. Although the program still reduced the deficit significantly, the tax hikes undermined potential economic growth more than permanent spending cuts would have, and the program overall did little to stem the most damaging day-to-day government expenditure.

In summary, emergencies are unlikely to be periods when the underlying microeconomics of government spending decisions will be carefully reviewed. Fiscal crisis

policymaking can therefore harm the growth potential of the economy with hasty decisions made in a moment of political panic. That unexpected policy change, of course, is also painful for households, who plan and budget based on expectations of their incomes. Sudden changes to tax policy or transfers make this extraordinarily difficult.

One reason governments borrow when genuine, unexpected emergencies like wars or pandemics hit is to engage in "tax smoothing," spreading the cost of red ink across generations and thereby reducing the volatility of marginal tax rates and incentives to work and invest. Being able to tax-smooth like this is dependent on having the capacity to absorb genuinely unexpected one-off shocks through government borrowing.

Preventing an ever-increasing growth of debt to enable this requires running balanced budgets or smaller deficits in good, non-crisis times. Now is certainly such a time, with unemployment at near-historic lows and the pandemic behind us. Deficit reduction today can therefore prevent a debt ratchet from necessitating sharp, unexpected changes in taxes or spending and the sorts of damaging policies we often see during fiscal emergencies.

3. Because High Debt Is Associated with Slower Economic Growth

Even if rising debt doesn't result in an outright fiscal crisis, there is plenty of evidence to suggest that high levels of government debt are associated with slower economic growth.

There is likely some two-way causation here. Slower growth prospects for a country worsen its underlying budget deficits, pushing up debt. But there are clear theoretical mechanisms through which very high debt may also *cause* slower growth. For example, extensive government borrowing, by competing with the private sector for funds, can push up interest rates and crowd out private investment. To make matters worse, debt can fund wasteful and destructive economic activity or government transfers that harm work incentives, undermining the potential size of the economy. If government debt gets very high, it also raises the prospect of much higher taxes or debt monetization and high inflation, each of which has a range of harmful costs on economic efficiency.[32]

The empirical literature finds a clear link between high government debt and slower economic growth. Economist Jack Salmon has examined the results of 40 studies published from 2010 to 2020 on the relationship between government debt levels and economic growth. Controlling for a range of other factors, the studies nearly consistently find that higher debt levels are associated with statistically significant evidence of slower growth.[33]

> "Debt-to-GDP level of around 80 percent seems to be a threshold beyond which debt is more harmful to growth."

Over three-quarters of these studies examine whether there is a particular threshold of government debt to GDP beyond which debt becomes more dangerous for growth prospects. Although there is no hard-and-fast rule, this sweep of literature implies that a debt-to-GDP level of around 80 percent seems to be a threshold beyond which debt is more harmful to growth. The United States is already above this threshold.

To be clear: crossing some arbitrary threshold doesn't automatically lead to disaster. This type of threshold analysis also got a bad rap after the work of economists Kenneth Rogoff and Carmen Reinhart was found to contain a coding error that exaggerated the negative relationship between debt and growth. Yet even those who critiqued that work admitted their own alternative analysis still showed that the mean GDP growth rate tends to be a percentage point lower for countries with debt-to-GDP ratios above 90 percent compared to those with debt-to-GDP ratios in the 60–90 percent range.[34] That may sound inconsequential, but an economy growing at, say, 2.5 percent per year will double in size every 30 years, whereas one growing at 1.5 percent per year will take about five decades to double.

Again, this risk to growth highlights the urgency of deficit reduction and reducing the path of future increases in debt.

BROAD LESSONS FROM SUCCESSFUL DEFICIT REDUCTION PROGRAMS

If we accept the premise that reducing future budget deficits is desirable, the next question is how to go about it. The preceding discussion has already alluded to one

important principle: making policy at the height of a crisis is unlikely to lead to the spending restraint that will help protect economic growth. For evidence of this, we need only to look at 2010s Europe, where rapidly adopted, tax-heavy deficit programs stifled economic growth.[35] Getting the microeconomics right requires a detailed look, ideally undertaken in good times, at the whole federal budget.

> "Making policy at the height of a crisis is unlikely to lead to the spending restraint that will help protect economic growth."

A second principle is that there is no get-out-of-jail-free card to avoid deficit reduction in the United States in the long term. Raising the economy's underlying growth prospects through supply-side reforms would also help obviate the need for *as much* deficit reduction and could ease the short-term squeeze of any adjustment.[36] So by all means, let's remove barriers to building housing and physical infrastructure; streamline the permitting process; provide more legal routes for immigration; eliminate costly and destructive regulations; and reform the tax code to eliminate market distortions. But most supply-side reforms take time and in conceivable magnitudes will get us nowhere close to filling the existing and projected budget holes. Policies to strengthen economic growth are worth doing and will ease the squeeze of deficit reduction, but they are highly unlikely to fully solve the problem.

The third principle, however, is arguably the most important. Worldwide experience with deficit reduction programs shows that government spending cuts, rather than tax hikes, are more successful in reducing debt without significantly impairing near-term economic growth.

The most detailed analysis of modern deficit reduction programs comes from the late economist Alberto Alesina and his coauthors Carlo Favero and Francesco Giavazzi. Their book, *Austerity: When It Works and When It Doesn't*, examined 184 deficit reduction plans undertaken between late 1978 and 2014 across 16 advanced economies, two-thirds of which were primarily focused on cutting spending, with the other third built around raising taxes.[37] Alesina and his coauthors found that deficit reduction programs that reduced government spending rather than raising taxes were far less damaging to economic output over a five-year period, and more effective in reducing debt burdens. Just as important, they also found that deficit reduction in Austria, Denmark, and Ireland in the 1980s and in Spain, Canada, and Sweden in the 1990s allowed those countries' economies to grow faster than they otherwise would have absent the spending cuts (see Box 1 for a case study of Canada).

There are potential explanations for why expenditure-focused austerity is likely to be less damaging to economic growth, and in some cases beneficial. Deficit reduction could help lower real interest rates, which can help boost private sector investment. It could also be that the spending being cut itself was damaging the economy's growth potential. For example, most subsidies reduce economic efficiency, and means-tested welfare-state transfer programs can reduce the supply of labor and create high effective marginal tax rates as people earn more, reducing incentives to work or invest in human capital. Or it could be that spending reductions reassured investors that the trajectory of future spending was more fiscally sustainable, reducing their expectations of future tax increases to reduce deficits.[38]

Alesina and his coauthors' results also hold for historic deficit reductions in the United States. As Figure 8a shows, they found that, after five years, the level of GDP tended to fall by more than twice as much from a 1-percent-of-GDP tax hike compared to an equivalent spending cut. They also made the significant finding that spending-based deficit reduction programs were more effective in reducing the path of debt relative to GDP (Figure 8b).

THREE PATHS FORWARD

Given the urgency of the issue, Congress should be working *now* to put together a long-term deficit reduction package. In an ideal world, this would defuse the debt time bomb associated with age-related entitlements programs by reducing the path of future spending, eliminating wasteful or economically harmful government programs, and enacting pro-growth tax and regulatory reforms to ease the burden of this adjustment.

Unfortunately, that is all easier said than done. Reforming entitlements, in particular, will likely require a sophisticated

Box 1

Case study on Canada

Canada was on the brink of a debt crisis in the early 1990s. The federal government had run deficits every year since 1970, and during the 1980s these deficits averaged 5.8 percent of GDP, levels not dissimilar to projected US deficits for the coming decade.

The 10-year bond yield hit 11 percent in 1990, meaning interest costs on Canadian government debt soared, peaking in 1991 at 6.5 percent of GDP, or around 29 percent of federal spending. The *Wall Street Journal* editorialized that growing government debt was making Canada an "honorary member of the third world" with the "northern peso" as its currency. Something had to be done.

Canada's left-of-center governing party, the Liberals, seized the challenge after their election in 1993. In the first Liberal budget in 1994, minister of finance Paul Martin provided some modest spending restraint. But in his second budget in 1995, he began serious cutting. In just two years, total non-interest spending fell by 10 percent.

The federal government slashed business subsidies, defense spending, welfare, aid to the provinces, and many other programs. Overall federal spending plummeted from 22 percent of GDP in 1995 to 17 percent by 2000, and down to 15 percent by 2006, the lowest level since the 1940s. From 1980 to 1995, 10-year federal bond yields averaged 12 percent higher in Canada than the United States, but from 1996 to 2022, Canadian bond yields have averaged 2.4 percent lower.

The Canadian economy boomed as spending was cut. Canada enjoyed strong economic growth and falling unemployment for 15 consecutive years until the Great Recession. Even the formerly weak Canadian dollar briefly soared to reach parity with the US dollar.

The Canadian episode reveals that government spending cuts can boost economic growth. The Canadian budget reductions were supported by microeconomic reforms, including the privatizations of Canadian National Railway, air traffic control, and several government corporations; deregulations in energy, telecom networks, and transportation; and marginal tax rate cuts. Such reforms can spur growth and thus ease dislocations when government spending is downsized.

Sources: "Fiscal Reference Tables," Government of Canada, 2023; Chris Edwards, "We *Can* Cut Government: Canada Did," *Cato Policy Report* 34, no. 3 (May/June 2012), pp. 1, 6, 7; author's calculations based on "Long-Term Government Bond Yields: 10-Year: Main (including Benchmark) for Canada," Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, updated January 12, 2024 and "Market Yield on US Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis," Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, updated February 23, 2024; Albert Tucker, "Canadian National Railway (CN)," *Canadian Encyclopedia*, last edited October 24, 2017; Civil Air Navigation Services Commercialization Act, Statutes of Canada (S.C.) 1996, c. 20; Allan Tupper, "Crown Corporation," *Canadian Encyclopedia*, last edited March 18, 2021; "Market Snapshot: 30th Anniversary of the Deregulation of Canada's Natural Gas Prices," Canada Energy Regulator, November 16, 2015; Dwayne Winseck, "Telecommunications," *Canadian Encyclopedia*, last edited December 15, 2013; K. Studnicki-gizbert, "Transportation Regulation," *Canadian Encyclopedia*, last edited August 19, 2014; and Chris Edwards, "Canada's Corporate Tax Cuts," commentary, Cato Institute, March 13, 2012.

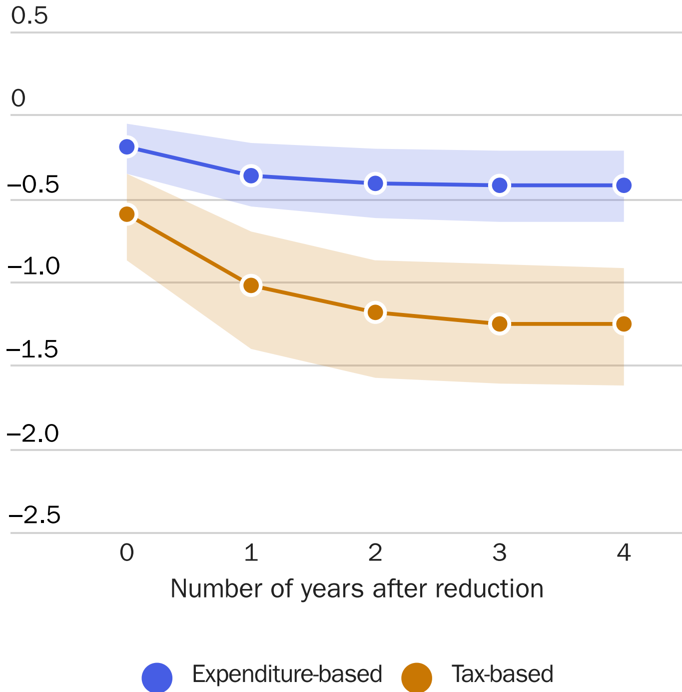
bipartisan approach, with mechanisms that help lower the political costs of voting to cut the value of future benefits. As the Cato Institute's Romina Boccia points out, a fiscal commission with broad scope and legislative teeth might be necessary to stabilize the federal debt relative to GDP.[39]

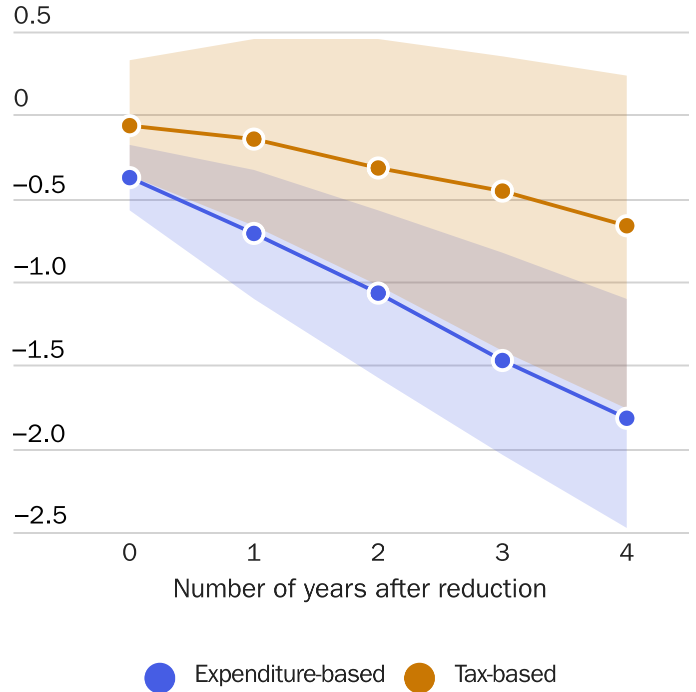
Even if entitlement reform looks like a distant prospect, we should still seek to reform the rest of the federal budget. We need to avoid the (very likely) prospect of policymakers leaving all meaningful deficit reduction efforts until fiscal crises have already hit. A second-best approach would thus be to deliver nearer-term deficit reduction predicated on reducing spending in other areas.

Table 1 uses the Committee for a Responsible Federal Budget's "Debt Fixer," as well as calculations by the Cato Institute's Chris Edwards, to identify non–health care and non–Social Security federal spending cuts that make economic sense. It estimates how much those cuts would reduce annual deficits, on average, over the next decade. Nobody pretends that making these cuts would be easy. And, when we are looking at almost $3 trillion annual deficits within a decade, it's obvious that these identified cuts alone (totaling almost $500 billion per year) would be insufficient to solve the longer-term debt problem. Entitlement reform is ultimately necessary for that.

Figure 8

The output and debt effects of a 1-percent-of-GDP deficit reduction in the United States, 1978–2014





Source: The data come from the replication package for Figures 1.2 and 7.12 in Alberto Alesina, Carlo Favero, and Francesco Giavazzi, *Austerity: When It Works and When It Doesn't* (Princeton, NJ: Princeton University Press, 2019).
Note: GDP = gross domestic product.

Table 1

Illustrative deficit reduction measures

Spending reform	Annual savings ($ billions)
Limit highway spending to dedicated revenue	43
Rescind Inflation Reduction Act climate tax credits	71
Devolve K–12 education to the states	65
Repeal President Biden's student debt cancellation and income-driven repayment plan	61
Means-test certain veterans benefits	33
Halve foreign aid and international program spending	38
Provide a pathway to citizenship for undocumented immigrants	21
Limit annual nondefense spending growth to 1 percent	33
Cut food stamps 20 percent	24
Reduce the cost of the federal workforce	16
Eliminate farm subsidies	25
End Department of Housing and Urban Development rental assistance, public housing subsidies, and community development grants*	66
Total average annual savings	**496**

Source: "Fix the National Debt," Committee for a Responsible Federal Budget, Debt Fixer.
Note: *2023 figures.

But in making some headway, Congress would at least reduce deficits at a time when the market signal of bond yields has been telling the government to borrow less money. Taking these measures would help mitigate the possibility of a full-blown fiscal crisis by displaying a seriousness to control borrowing at a time when bond markets have been volatile, and the country faces the prospect of higher age-related spending and borrowing in the future.

Even if deficit reduction proves politically impossible at this time, a third option would be for the federal government to create and annually update a fiscal resolution plan or "living will" in which policymakers detail emergency spending cuts that could be enacted in response to an unanticipated fiscal crisis.

> "A fiscal resolution plan might help reduce the chaos of producing policy in the fog of a fiscal crisis."

A fiscal resolution plan might help reduce the chaos of producing policy in the fog of a fiscal crisis by giving policymakers options for austerity that were debated and considered in advance. This document is not the place to flesh out the precise details of how this would work, but such a plan would ideally be created by a special bipartisan committee of representatives and senators, along with the Department of the Treasury, and updated regularly. Its remit should be to outline spending changes that, combined, would eliminate the country's expected primary deficit (i.e., the deficit excluding interest costs, which is expected to average $750 billion over the next decade). At a minimum, having such a document would provide Congress and the president with concrete spending cuts to at least start the rapid negotiations that would ensue at the start of any fiscal crisis.

CONCLUSION

The sharp rise in bond yields since 2022 is a further warning to politicians in Washington about the risks associated with rising federal debt. For years, budget analysts have talked about how the federal finances are on an unsustainable path. Politicians nevertheless borrowed vast amounts during the Great Recession and the COVID-19 pandemic and even began running larger and larger deficits outside of those emergencies.

A higher cost of borrowing will accelerate the need for offsetting deficit reduction to keep debt under control, while leaving the federal finances more vulnerable to unforeseen events that could precipitate a full-blown fiscal crisis. It heightens an already strong case for deficit reduction.

Ideally, this deficit reduction would entail meaningful reform of entitlement programs and a fundamental reexamination of the role of government, focused on cutting expenditure. If that proves beyond the capability or willingness of Congress, there are still significant amounts of day-to-day expenditure that it would be preferable to cut before reaching for growth-destroying tax increases.

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