America’s Exploding Budget Deficit

By Martin Feldstein *Thu, Jun 7, 2018*

The U.S. should slow the cost of Social Security by raising the age threshold for receiving full benefits to 70 from 67, recommends Harvard's deficit hawk.

The United States has an enormous and rapidly widening budget deficit. Under existing law, the federal government must borrow $800 billion this year, and that amount will double, to $1.6 trillion, in 2028. During this period, the deficit as a share of GDP will increase from 4% to 5.1%. As a result of these annual deficits, the federal government’s debt will rise from $16 trillion now to $28 trillion in 2028.

The federal government’s debt has risen from less than 40% of GDP a decade ago to 78% now, and the Congressional Budget Office (CBO) predicts that the ratio will rise to 96% in 2028. Because foreign investors hold the majority of US government debt, this projection implies that they will absorb more than $6 trillion in US bonds during the next ten years. Long-term interest rates on US debt will have to rise substantially to induce domestic and foreign investors alike to hold this very large increase.

Why is this happening? Had last year’s tax legislation not been enacted, the 2028 debt ratio would still reach 93% of GDP, according to the CBO. So the cause of the exploding debt lies elsewhere.

The primary drivers of the deficit increase over the next decade are the higher cost of benefits for middle-class older individuals. More specifically, spending on Social Security retirement benefits is predicted to rise from 4.9% of GDP to 6%. Government spending on health care for the aged in the Medicare program – which, like Social Security, is not means tested – will rise from 3.5% of GDP to 5.1%. So these two programs will raise the annual deficit by 2.7% of GDP.

This officially projected increase in the annual deficit would be even worse but for the fact that the cuts in personal income tax enacted last year will lapse after 2025, reducing the 2028 deficit by 1% of GDP. The official deficit projections also assume that the recently enacted increases in spending on defense and non-defense discretionary programs will be just a temporary boost. Defense spending is expected to decline from 3.1% of GDP now to 2.6% in 2028, while the GDP share of non-

defense discretionary spending will fall from 3.3% to 2.8%. These deficit-shrinking changes are unlikely to happen, causing the 2028 deficit to be 7.1% of GDP – two percentage points higher than the official projection.

If a deficit amounting to 7.1% of GDP were allowed to occur in 2028, and to continue thereafter, the debt-to-GDP ratio would reach more than 150%, putting the US debt burden in the same league as that of Italy, Greece, and Portugal. In that case, US bonds would no longer look like a safe asset, and investors would demand a risk premium. The interest rate on government debt would therefore rise substantially, further increasing the annual deficits.

Because financial markets look ahead, they are already raising the real (inflation- adjusted) interest rate on long-term US bonds. The real rate on the ten-year US Treasury bond (based on the Treasury's inflation-protected bonds) has gone from zero in 2016 to 0.4% a year ago to 0.8% now. With annual inflation running at about 2%, the increase in the real interest rate has pushed the nominal yield on ten-year bonds to 3%. Looking ahead, the combination of the rising debt ratio, higher short- term interest rates, and further increases in inflation will push the nominal yield on ten-year bonds above 4%.

What can be done to reduce the federal government's deficits and stem the growth of the debt ratio? It is clear from the forces that are widening the deficit that slowing the growth of Social Security and Medicare must be part of the solution. Their combined projected addition of 2.7% of GDP to the annual deficit over the next decade is more than twice the officially projected rise in the ratio of the annual deficit to GDP.

The best way to slow the cost of Social Security is to raise the age threshold for receiving full benefits. Back in 1983, Congress agreed on a bipartisan basis that this threshold should be raised gradually from 65 years to 67, cutting the long-run cost of Social Security by about 1.2% of GDP. Since 1983, average life expectancy of individuals in their mid-sixties has increased by about three years. Raising the future age for full benefits from 67 to 70 would cut the long-run cost of Social Security by about 2% of GDP.

At this time, slowing the growth of Social Security and Medicare is not a politically viable option. But as the deficit increases and interest rates rise, the public and the Congress might return to this well-tried approach.