THE US NATIONAL DEBT

Our Gift for Future Generations

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A. Overview

The national debt is historically high and getting larger every year. No one knows for certain, but the higher the debt-to-GDP ratio, the less likely it becomes that the country will be able to pay back its debt and the higher its risk of default. Default could cause a financial panic in the domestic and international markets. Even before that point, interest rates that the US government will have to pay investors to accommodate its deficit spending will continue to increase which in turn will accelerate the debt crisis. Many economists think Total Debt/GDP ratios of 150 - 200% will result in a catastrophic scenario. We are currently at about 100% when historically for the last 80 years we have averaged 65%.

B. Economic Factors

Revenues
Government revenue at the federal level in the US, comes primarily from taxes, with individual income taxes being the largest single source, followed by payroll taxes for social insurance programs, and corporate income taxes. At the state and local level, revenues come from property taxes, sales taxes, income taxes, and grants from the federal government. Fuel taxes are levied on gasoline and diesel purchases which are used to fund highway and mass transit projects and maintenance.

In the US, total annual tax revenue (federal and state) comes to about 27% of the annual GDP. This compares to an annual average of 34% for OECD countries (Organization for Economic Cooperation and Development). For Example, Ireland and Mexico have ratios less than the US while eight northern European countries have ratios greater than 40%. A breakdown of these taxes shows the US collects more from personal income and property taxes based on a percentage of the total taxes collected compared to OECD countries, 53% to 34%. OECD countries collect a larger percentage of their total tax revenue from social security taxes and taxes on goods and services which includes VAT (value added tax), which is a national sales tax.

For tax year 2022, US tax filers had total AGI (adjusted gross income) of about $14.8 trillion in income, and the federal government collected about $2.1 trillion in income taxes which amounted to about 50% of the total federal revenue. Of the total collected, the top 10% of income earners made 49% of the total income and they paid 72% of the total taxes. For 2022, an income of about $178,000 would be the low end of this 10%

bracket. The next 40% of income earners ($50,000 to $178,000) had 40% of the total AGI income and they paid 25% of the total income taxes. The bottom 50% of filers earned 11% of the total AGI income and paid 3% of the taxes.

Spending

Government spending at the federal level was approximately $6.75 trillion for fiscal year 2024 and consisted mainly of mandatory, discretionary and debt service outlays. Mandatory spending is mostly entitlement programs controlled by laws requiring spending on specified programs. In 1962, mandatory spending was 26% of the total budget and in 2024 it had risen to 60%. It covers entitlement programs like social security and Medicare and has experienced this rapid increase due to an increased elderly population, and entitlement laws such as implementing Medicare and Medicaid in 1962, the earned income tax credit in 1975, and the child tax credit in 1997.

Discretionary spending covers the funding of programs that require regular appropriations renewed by Congress. In 1962 discretionary spending comprised 50% of the budget and in 2024 the percentage had dropped to 26% accounting for some of the increase in mandatory spending. 45% of discretionary spending goes to the military and most of the rest to domestic programs such as transportation, education, environment, veterans, and other healthcare programs. Foreign aid comprises 4% of the discretionary spending budget. Keep in mind that even though the discretionary spending percentage of the total budget dropped from 1962, actual payment totals increased from $107 billion to $1.8 trillion, a 1700 percent increase.

Debt service on borrowed money to cover annual spending deficits has risen to 13% of the federal budget as of 2024, which exceeds defense spending. From 2016 to 2021, interest rates were at historically low levels which held down interest payments even as the national debt increased compared to the GDP. This is changing as interest rates for US securities are double what they were at during this earlier period, and as the debt to GDP ratio goes up this will have a continuing negative impact on rates.

Projections

The Congressional Budget Office (CBO) is projecting that the total national debt will increase to around 120% when compared to the estimated GDP for 2035, which would be a historically high ratio. About that same year, the social security trust fund will be depleted, and if deficit spending isn't increased to cover the shortfall, social security benefits will be cut by 17%. Debt service alone will account for about 17% of the total annual budget estimated to be $10.6 trillion. For the year 2055, the CBO projects a debt to GDP ratio of about 156% which could slow economic growth, increase interest rates for government borrowing, and pose significant risks for the fiscal and economic outlook of the US.

For its projections, the CBO assumes interest rates for US securities to be capped at 3.8%, that recent tax cuts will be allowed to expire in the future, discretionary spending will not increase as much as they historically have over the last few decades, and mandatory spending percentages will decline over the next 30 years. Any, or all of these assumptions could be difficult or impossible to achieve and it may be interesting to look at the projections if current policies and trends are allowed to continue.

The Manhattan Institute, an admittedly conservative think tank, has made 30-year projections based on current policy objectives instead of the limitations assumed by the CBO. Interest rates on US securities alone have already inched about 4% so the CBO projections are already optimistic. If more conservative assumptions are made regarding these issues, the debt to GDP ratio will soar to 235% instead of 156% as currently projected. This will be an untenable situation for the US economy.

C. Economic Considerations

Increase GDP

In order to maintain debt-to-GDP ratios at sustainable levels of 100% or less it will be necessary to increase GDP, reduce deficit spending, increase revenues, or institute policies that will combine all of these factors. Political candidates routinely promise to address deficits by producing economic growth rates of 4% and even 5% while citing the fast economic growth in the decades following World War II. The first problem with this promise is that the economic growth post-World War II was primarily driven by the large labor-force expansions of women and then baby boomers. However, the size of the labor force is projected to grow by just 0.1% annually over the next 50 years as the baby boomers retire, birth rates slow, and immigration rates dip.

That leaves productivity to drive nearly all economic growth. The CBO estimates that GDP will increase by 1.1% annually for the next three decades, which is what the economy has done over the past three decades. That will result in their debt ratio of 156% for 2055. In order to reduce this ratio to 100%, the GDP would have to grow by almost 2% annually above what the CBO projects, or about 3.1% per annum. To achieve the same result using the Manhattan Institute's projections, the GDP would have to grow by 4.25% per annum.

Much can be done to increase real economic growth rates above CBO's long-term projections including trying to grow the labor-force participation rate, refining the tax code to encourage savings and investment, and improving policies in the areas of trade, energy, job training, education, and health care. However, a refusal to address surging deficit spending will still undermine economic growth by raising interest rates, decreasing business investment, and ultimately forcing up taxes. Lawmakers should aspire to faster growth but not simply assume it will happen, especially if entitlement costs keep growing.

Smart immigration policy may marginally improve the federal budget picture by increasing GDP, but it's not a cure-all for the debt-to-GDP ratio. Immigrants contribute tax revenues during their working careers, but their eventual retirement into Social Security and Medicare would add new liabilities to the system in the future. Low-skill immigrants generally increase costs to the federal government (and especially to state and local governments) because the resulting education, infrastructure, and social spending exceeds the added tax revenues. While immigration can fill labor market shortages for certain economic sectors, it won't adequately address the national debt crisis.

Increase Revenues

Increasing revenues while capping spending could be implemented to reduce or decelerate a debt-to-GDP ratio. However, "Tax the Rich" advocates often vastly overstate the degree to which upper-income tax increases can finance the ever-expanding government. In addition, instituting a policy like this to the extremes necessary to sustain a healthy debt ratio would likely reduce investment and business expansion which would have the knock-on effect of reducing wages, slowing job growth, and lowering overall economic growth. There are approximately 800 billionaires in the US holding a combined $6.2 trillion in net worth which raises ethical issues . But if we were to confiscate their entire savings, investments, houses and cars we could pay for three years of deficit spending at the existing rate. Simply put, there aren't enough billionaires to finance a "tax the rich" utopia.

As noted above in the Revenue section, The US collects tax revenues at about 7% lower than the average OECD country. But nearly this entire difference results from the other countries hitting their middle class with national sales taxes or VATs. Even the oft cited progressive countries of Norway and Sweden, which exceed tax revenues of the US by 16%, achieve this mainly by higher payroll and VAT revenues that broadly hit the middle class. Looked at another way, Europe finances its progressive spending levels on the backs of the middle class, not just the wealthy. If the U.S. wants to spend like

Europe, it must also tax like Europe, which would include a VAT that rises to over 20% or even 30% or, a doubling of the payroll tax. Also, any VAT revenue increase, without net worth exemptions, would significantly impact lower income families.

Selective tax increases should be considered when proposing solutions to the national debt crisis, but tax increases by themselves will not achieve the desired result unless they are draconian in nature.

Decrease Spending

Spending cuts will also improve the debt-to-GDP ratio. Some have advocated for cuts in discretionary spending, specifically to the military budget. Over the past 40 years, the defense budget has fallen from 6% to 3% of GDP, not because spending has decreased (in fact it's increased0, but the overall federal budget has increased so significantly that defense spending is becoming a smaller piece of the pie. US spending for defense is not far above Europe's target of 2%. Cutting U.S. defense spending to the levels pledged by European members of NATO would save 1% of GDP, or less than one-fifth of the Social Security and Medicare noninterest shortfall by the 2040s and 2050s.

Some have advocated for a Medicare-for-All program which they argue will drastically slash costs to families and the federal budget. Despite optimistic projections that single-payer health care can bring a streamlined payment system that squeezes dramatic efficiency savings out of excess profits, salaries, and administrative bloat, health-care economists on the left and the right are quite skeptical that significant savings can be achieved without driving health providers out of business. The most likely scenario is that total national health expenditures remain roughly unchanged under Medicare-for-All by shifting private health expenditures over to the federal government. A new tax would have to be implemented to achieve this, but none of this will result in lower spending. This isn't an argument for or against Medicare-for-All, but rather it likely would have little impact on the national debt calculations.

To achieve the biggest impact, reductions in mandatory spending will have to be considered. And the elephant in the room when it comes to federal spending is social security and Medicare. Of course, any significant spending reductions will also have the added benefit of reducing debt service expenses. Without reforming those two entitlement programs, there is no package of remotely plausible alternative spending cuts or tax hikes that could cover the budget shortfall.

D. Potential Fixes

Increase Revenue and Decrease Spending

The most effective way of reducing the national debt, or at lease limiting the debt ratio to 100%, is to combine an increase in revenue (additional taxes) with spending cuts to Social Security and Medicare. Any fundamental redesign of Social Security and Medicare must be bipartisan to have any credibility with voters and be sustained over the long-term. And this bipartisan effort will have to include significant tax concessions, themed around shared sacrifice, as Americans will never accept deeper-than-necessary cuts to their prized benefits just to ensure that billionaires are shielded from any new taxes.

These changes will need to be implemented sooner rather than later. Each year of delay will likely ensure a more tax-heavy final solution. A decade from now, higher interest rates and a much larger debt will require even greater immediate savings. At the same time, the 74 million retired baby boomers will be too old to absorb the benefit changes to their entitlements, that will result in a reduction of the national debt.

The Social Security and Medicare debate often brings opposition to reform based on the myths that most seniors are poor, and seniors are simply getting back the money they paid into these programs. Unlike 1930 when social security was created, senior citizens are the wealthiest age group of Americans in history. Millions of retiree households continue to earn incomes greater than $100,000 even after retirement, driven by retirement accounts that have grown 60% faster than inflation since 1980. Today most retirees are wealthier than the taxpayers financing their benefits with income redistribution going upward. There are many seniors who are at the lower end of net worth, but their situation can be addressed by raising the minimum net worth limit. But still, today’s seniors have the lowest poverty rate of any age group.

The relative wealth of seniors should influence the conversation of the second myth that seniors are merely getting back what they paid in. A middle-earning couple turning 65 years old next year will have paid $1.0 million over their lifetime into Social Security and Medicare yet receive $1.5 million in benefits (all adjusted into present value). Lower-earners as well as one-earner couples will come out even further ahead. Policymakers must decide if it makes sense to raise taxes on working families by a staggering amount in order to ensure that even millionaire seniors can continue to receive Social Security and Medicare benefits far exceeding their lifetime contributions to those systems.

E. Budget Plan

Goal: Stabilize the national debt at 100% of GDP by 2055 through spending cuts and tax increases. The following summarizes one such budget plan as presented by Jessica Riedl from the Manhattan Institute in the article entitled *A Comprehensive Federal Budget Plan to Avert a Debt Crisis* from June 27, 2024.

Spending Cuts

1. Social Security (32% of cuts)
   Raise full benefit retirement age to 69 by 2035. Trim benefit formulas for the top 50% of retirees. Calculate social security cost adjustments based on price indices instead of wage inflation. Set a minimum benefit of 125% of the federal poverty line.
2. Medicare (34% of cuts)
   Implement efficiency reforms such as tying premium support payments to the average cost of all plans available, whether a "Traditional Medicare" or "Advantage Plan". Maintain Medicare Part B and D premiums for the bottom-income 50% of retirees, yet gradually rise with income until the highest earners pay 95% of the cost of the insurance coverage for Part B and 85% for Part D
3. Medicaid (11% of cuts)
   Phase out the enhanced 90% federal reimbursement rate of the eligible population of non-disabled, working-age adults while retaining their eligibility and rates similar to other Medicaid recipients such as seniors and the disabled.
4. Other Mandatory Spending (10% of cuts)
   Limit spending growth to the inflation rate plus population growth instead of allowing it to expand based on GDP growth only
5. Discretionary Spending (13% of cuts)
   Temporarily freeze appropriations and then cap annual growth at 3.5% thereafter. This will be for both defense and non-defense discretionary spending

Revenue Increases:

1. Raise top income tax bracket from 37% to 39.6% (4% of increase)
2. Raise Medicare payroll tax rate by 1 percentage point to be split between employer and employee (14% of increase)
3. Cap tax exclusion for employer-provided health care at 50% of the average premium (38% of increase). Many economists agree that the employer health exclusion encourages businesses to overspend on health benefits and downplay cost-containment, while disproportionately benefitting upper-income employees who would otherwise pay higher tax rates on that compensation. It also penalizes families that buy their own health insurance and do not get a tax break
4. Cap value of itemized tax deductions at 15% of amount deducted (7% of increase)

5. Impose a modest carbon tax with the cost rebated to all but the top-earning 25% of households (3% of increase)
6. Repeal Tax Cuts and Jobs Act's (TCJA) 20% pass-through business deduction (14% of increase)
7. Repeal step-up basis on inherited capital gains (2% of increase)
8. Repeal energy credits in the Inflation Reduction Act (6% of increase)
9. Extend IRA's funding for IRS tax enforcement beyond 2031 to maximize collection of owed taxes (2% of increase)
10. Raise gas tax by 15 cents per gallon and index for inflation (3% of increase)
11. Other small tax reforms (6% of increase)
12. End Social Security payroll tax at age 62 (zero net cost)

Those who would prefer that all new taxes come from upper-income taxpayers should note that these taxpayers would already bear nearly the entire cost of Social Security and Medicare reforms, in addition to about 50% of the new taxes and most of the cost of scaling back the employer health exclusion. The bottom half of earners would see only a 1% payroll tax hike (which will help finance their own Medicare benefits) and a small gas-tax increase (a user fee needed to close the shortfalls in the highway program)—plus the benefits of no Social Security payroll taxes beginning at age 62. Given the principle that everyone should contribute to closing these shortfalls, low-earners are overwhelmingly shielded from new costs.

F. Income Group Impacts

Well-off retirees will shoulder most of the costs of bringing Social Security and Medicare finances to a sustainable level. The wealthiest half of seniors often have incomes and net worths that exceed those of young workers, while typically not having mortgage or child-raising expenses. To this end, the income impacts to all seniors in the top 50% of income will be impacted the most, and not just the ultra-wealthy. Well-off seniors have not adequately shared in the funding of the benefits that they’re receiving, or have received, and these impacts will address that shortfall. No one will necessarily be happy with any of this, but everyone should realize the gravity of the situation and accept the shared responsibility. The following summarizes the financial impacts to different income groups with costs adjusted for inflation.

1. Seniors with household incomes below the 50th percentile
   Largely unchanged for Social Security and Medicare benefits although the eligibility age rises
2. Senior households in the 50–60th income percentile

With an average household income of $92,000 in 2035, this group will face approximately $2,700 less than currently estimated in annual Social Security benefits and $2,800 in higher Medicare premiums. This 6% of income loss will rise to roughly 10% by 2055

3. Senior households in the 60–80th income percentile
   With an inflation-adjusted average household income of $137,000 in 2035, this group would face approximately $4,200 less in annual Social Security benefits and $7,300 in Medicare changes, totaling 8% of their income, and rising to 12% by 2055. This burden would not be easy, although the retirement income of this group would well exceed the income of many families that would otherwise be taxed to finance their benefits
4. Retiree households in the 80–90th income percentile
   Retiree households with average household incomes of $257,000 by 2035
   This group would experience a decline in their projected Social Security benefits of $5,700 and a rise in Medicare premiums of $15,000. This would average 8% of their income in 2035, rising to 11% by 2055
5. Highest earning 10% of retiree households
   Retiree households with average household incomes of $478,000 by 2035 would experience a decline in their projected Social Security benefits of $7,400 and a rise in Medicare premiums of $5,700. This would average 3% of their income in 2035, rising to 5% by 2054. This figure is dampened by the fact that these households already pay as much as 85% of their Medicare Part B and D plan costs, which leaves less room to raise their premiums, and also will be paying most of the revenue increases which will limit the benefit reductions for everyone

Primary Resource Used for This Paper
https://manhattan.institute/article/a-comprehensive-federal-budget-plan-to-avert-a-debt-crisis-2024