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Understanding Public Debt

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The American Institute for Economic Research educates people on the value of personal freedom, free enterprise, property rights, limited government, and sound money. AIER's ongoing scientific research demonstrates the importance of these principles in advancing peace, prosperity, and human progress.

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Part 1: What is Public Debt?

Public debt, sometimes called government debt, is money borrowed by governments. Like all debt, public debt finances spending today by borrowing on the promise to repay what is borrowed in the future with interest. Richard E. Wagner, an economist who has studied the borrowing of money by governments, explains the process of government borrowing by noting that democratic governments act as financial intermediaries, bringing together lenders and borrowers, "some willingly and others forcibly."[1] He observes that those willing to borrow are those who want greater spending today for their preferred programs despite a lack of current resources, while those who are forced would prefer lower taxes in the future over government programs today.

Public debt is not a new phenomenon. Governments and rulers in nearly every civilization have taken on public debt to finance large government projects, especially war and infrastructure. The rise of commercial society and the wealth it spawned made it easier for those in government to borrow money to finance spending of all sorts. As the merchant class became wealthier, the government found a growing pool of lenders who were happy to lend to the government with the promise of being paid back with interest. Writing in 1776, Adam Smith noted,

> The government of [a commercial state of society] is very apt to repose itself upon this ability and willingness of its subjects to lend it their money on extraordinary occasions. It foresees the facility of borrowing, and therefore dispenses itself from the duty of saving.[2]

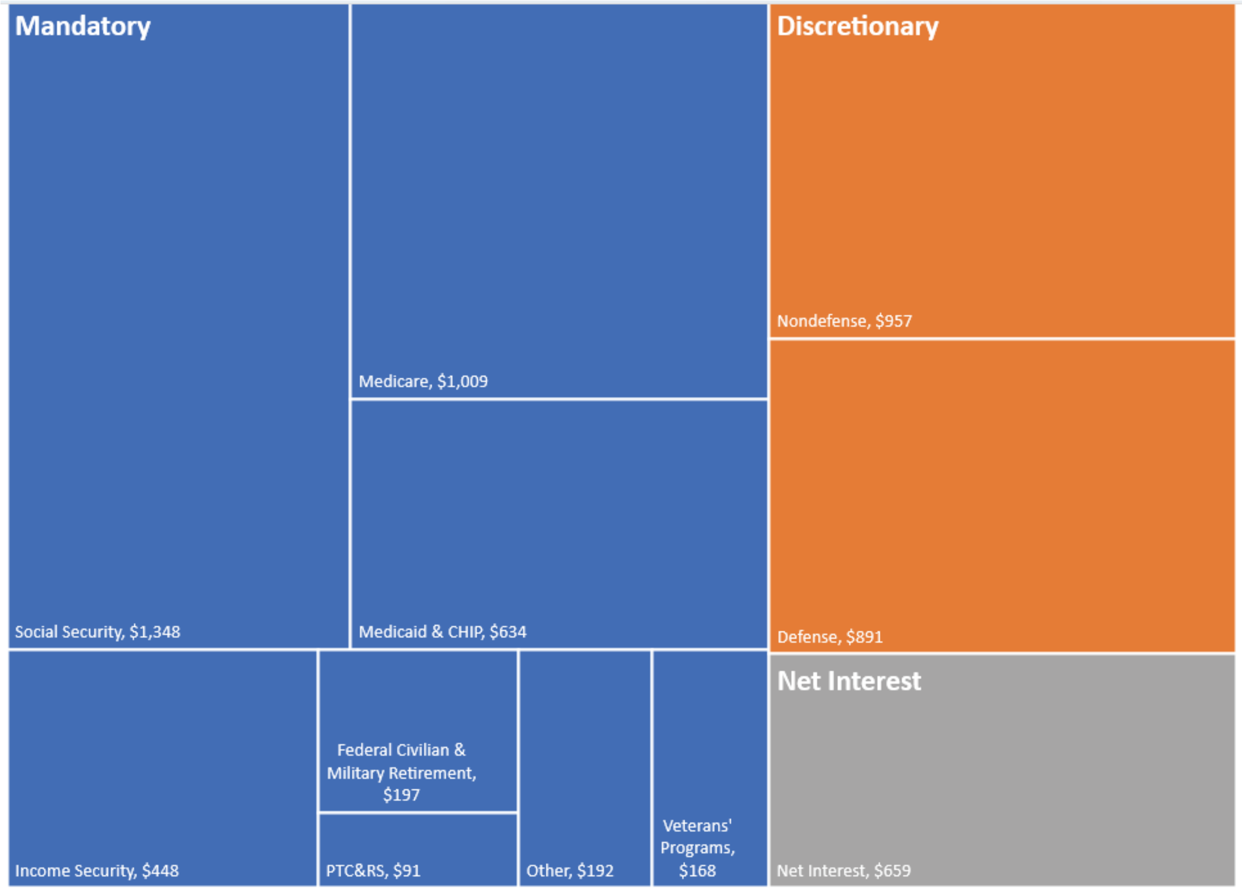
Smith's observation describes the current circumstances faced by the United States government. At all levels of government, willing lenders are happy to lend money and buy US Treasury securities and municipal bonds, allowing federal, state, and local governments to fund spending today by promising to pay in the future. This Explainer looks at that public debt, its impact on taxpayers, and what, if anything, can be done to mitigate the scope and impact of that debt.

WHAT IS THE NATIONAL DEBT?

The public debt most Americans think of first is the national debt accrued by the US federal government and sold as marketable (someone can transfer or sell the security to someone else before it fully matures) and non-marketable (cannot be sold to other investors) debt.[3]

This debt is further broken down into intragovernmental debt and debt held by the public.[4] Intragovernmental debt is owed by one part of the federal government to another. The most common example of intragovernmental debt is the Treasury securities owned by the Social Security Trust Fund. Debt held by the public simply means securities held by a person or entity that's not a US federal government agency. The current national debt is around $34 trillion and rising, with about $27 trillion held by the public and $7.12 trillion held by US federal agencies.

Figure 1: Federal Spending by Category



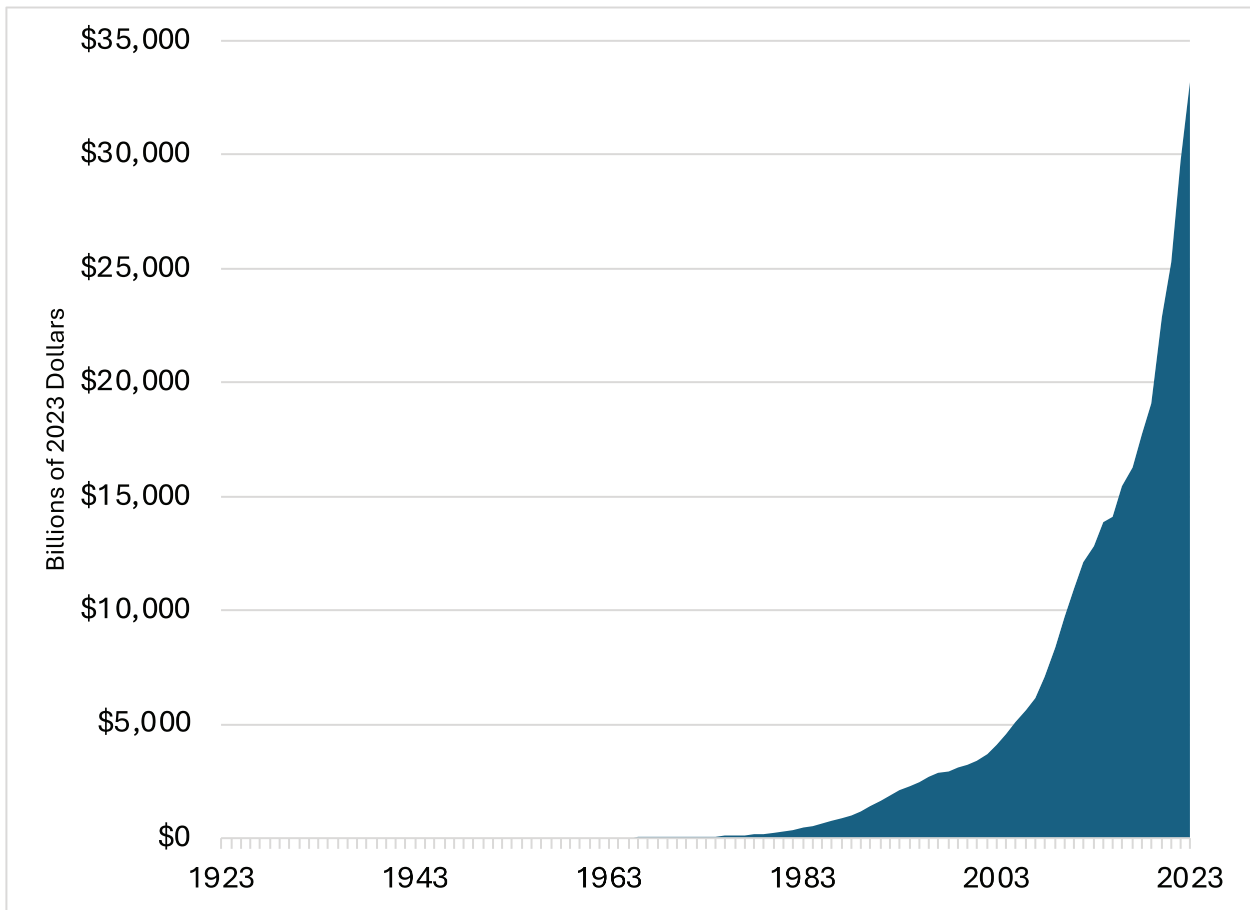
"The Budget and Economic Outlook: 2024 to 2034." United States Congressional Budget Office. Feb 2024. Accessed February 24, 2024. <https://www.cbo.gov/publication/59946>

The size and scope of the national debt is enormous, and like all debt is driven by the reality of spending exceeding resources and an expectation that future taxpayers will be able to pay for today's programs and activities. At its core, the ballooning debt is driven by a spending problem: Federal expenditures have long outpaced federal revenues, and the trend will continue well into the future. Figure 1 above shows the largest spending categories, with Social Security being the single largest spending category.

HOW MUCH DOES THE FEDERAL GOVERNMENT OWE? TO WHOM?

As of July 2024, the national debt is around $34.58 trillion ($103,750 for every man, woman, and child in the United States) and continues to climb. The debt jumped in the wake of the Great Recession as well as during the economic downturn of 2020. In both cases, the debt was driven by large spending increases. Policymakers financed this this spending increase in large part by borrowing money because interest rates were at historic lows.[5] Figure 2 shows just how much the debt has grown in the past hundred years.

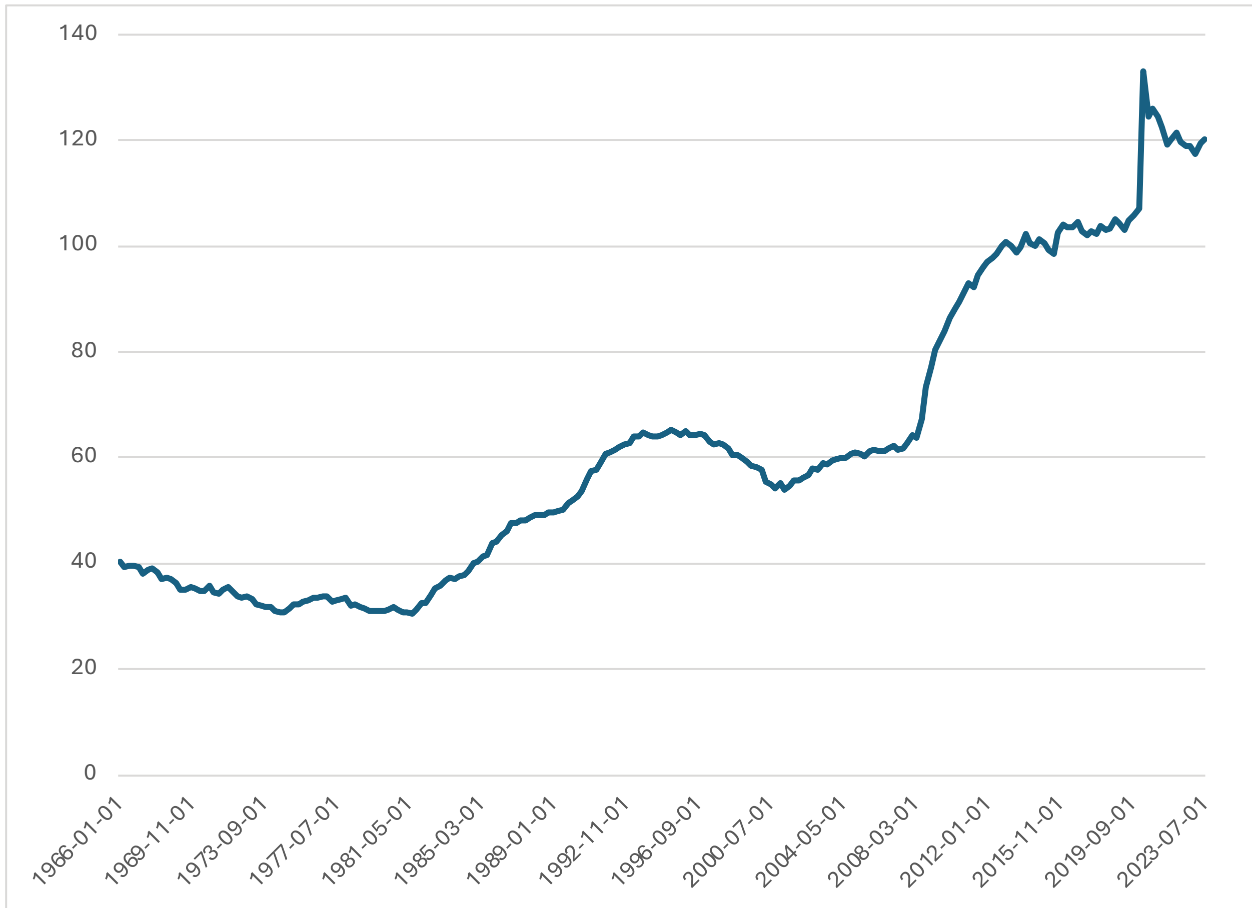
Figure 2: Total Debt



Sources: US Department of the Treasury. Fiscal Service, Federal Debt: Total Public Debt [GFDEBTN], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GFDEBTN, and US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in US City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPIAUCSL, March 1, 2024.

Looking at the amount of debt is not sufficient to understand its impact on the American people, just like knowing how much a person owes isn't enough to understand how owing impacts that person's daily life. How fast the debt is growing, and the impact it has on the economy, are important considerations that the simple amount doesn't reveal. Indeed, when we look at Figure 3, we see the National Debt as a Percentage of Gross Domestic Product (GDP).

Figure 3: Total Public Debt as a Percent of Gross Domestic Product

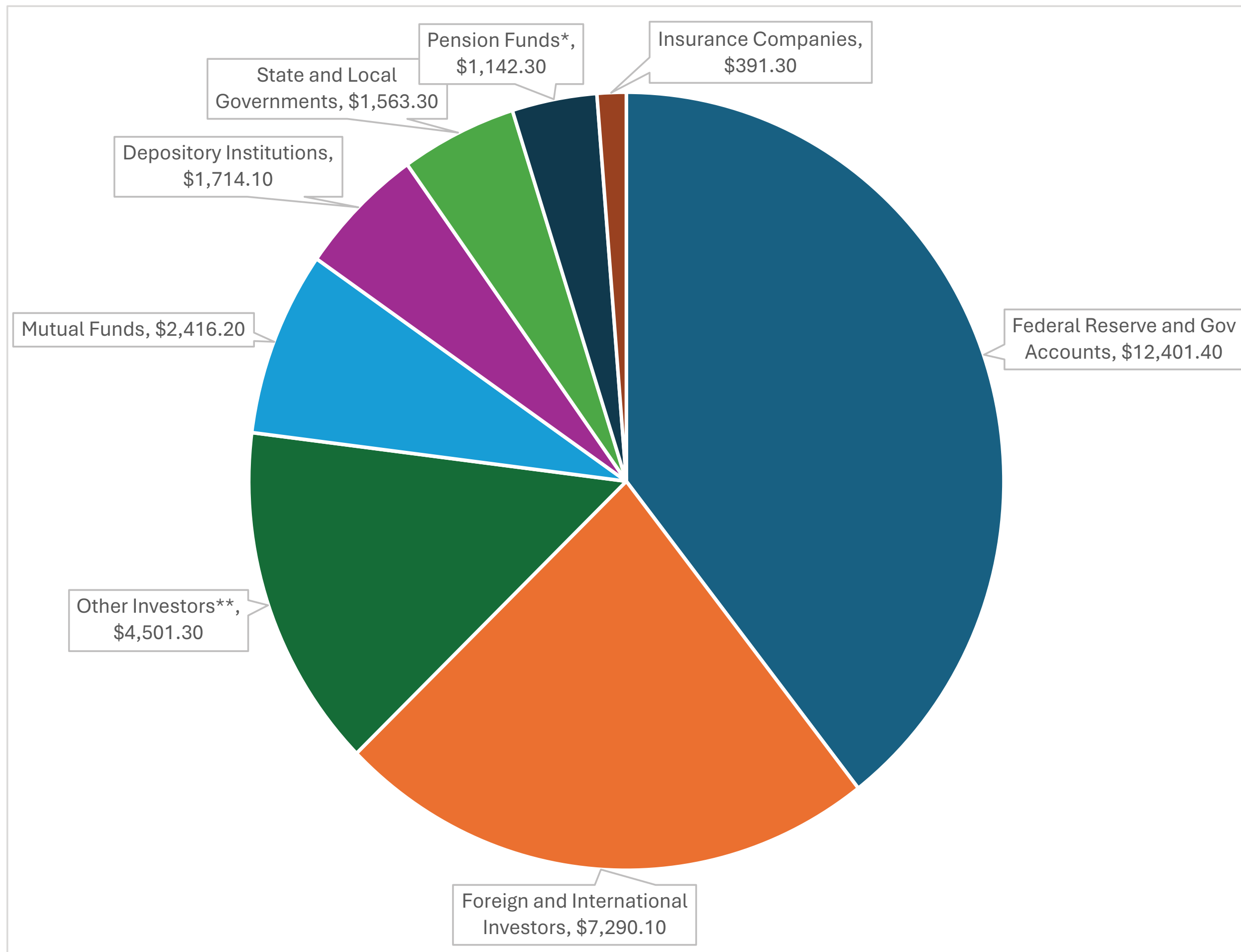


Source: US Office of Management and Budget and Federal Reserve Bank of St. Louis, Federal Debt: Total Public Debt as Percent of Gross Domestic Product [GFDEGDQ188S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GFDEGDQ188S, March 1, 2024

As of July 2024, the latest estimates of the total public debt (national debt minus government transfers) is 121.6 percent of GDP, well past the previous high of 110 percent during World War II. Debt as a percentage of GDP, like a person's debt-to-income ratio, is an important indicator of a government's ability to pay its debts. The larger the debt-to-GDP ratio grows, the more difficult it will be for the government to pay its debts and for the economy to simply grow its way out of the debt.

With a $34.58 trillion dollar debt, is important to know to whom the government owes all this money. Figure 4 below shows the investor categories in US Treasury Notes.

Figure 4: Who Owns The National Debt? (Billions of Dollars)



**Includes private pensions funds as well as state and local government pension funds*
***Includes individuals, government-sponsored enterprises, brokers and dealers, bank personal trusts and estates, corporate and non-corporate businesses, and other investors. Also Includes US Savings Bonds Source: "US Treasury Monthly Treasury Statement (MTS)" Bureau of the Fiscal Service, US Department of the Treasury. March 2024. https://www.fiscal.treasury.gov/reports-statements/mts/*

As we noted above, the largest single holders of the national debt are intragovernmental holders of the Federal Reserve System and other Intergovernmental Transfers. Since the Great Recession, the Federal Reserve had doubled its holdings from 2020-2022 as part of the massive federal stimulus plans responding to the Coronavirus (COVID-19) Pandemic but has since shifted gears and sold off some assets to combat inflation.

The second-largest category is "Foreign and International Investors." This category consists of foreign governments (who own a little more than half of the debt in this category) and foreign private investors (who own a little less than half of the debt in this category).[6] As of December 2023 the three foreign governments that held the most US debt were Japan, China, and the United Kingdom.[7]

"Other Investors," the third largest category, includes individuals, government-sponsored enterprises, brokers and dealers, bank personal trusts and estates, corporate and non-corporate businesses. The smaller categories of holders, such as mutual funds, depository institutions, pension funds (both public and private), state and local governments, and insurance companies also hold debt.

Ultimately, these diverse groups of investors all hold US Treasury debt because it is a low-risk, interest-bearing investment. They trust that their loans to the US government will be paid back with interest and that "the full faith and credit of the United States" is a reliable promise. [8, 9]As debt continues to grow to unsustainable levels, however, the trust in that promise erodes. That erosion of trust is most clearly displayed by credit-rating downgrades. In August 2023, Fitch Ratings downgraded the US credit rating from AAA to AA+, which followed the August 2011 lowering by Standard and Poor's.[10] In November 2023, Moody's Investment Service changed the US credit outlook to negative.[11] While these credit downgrades don't guarantee a fiscal crisis will occur, lower credit ratings mean that the US government must offer higher interest rates to keep investors interested in US debt. Net interest costs are already the second largest expenditure for the federal government (after Social Security).[12] As borrowing costs rise further, debt service costs will crowd out other federal expenditures, and eventually force the federal government to enact painful tax hikes and spending cuts so funds can be diverted to pay for the debt.

WHAT'S NOT INCLUDED IN THE NATIONAL DEBT?

The national debt does not include all forms of public debt. Neither debt owed by state and local governments, nor unfunded obligations to programs like Social Security or Medicare are included in it. These unfunded obligations represent spending that will have to occur, and where borrowing is the most likely source of the funds, leaving taxpayers on the hook to pay for this future borrowing.

Unfunded obligations refer to the Social Security and Medicare benefits promised to current and future retirees that are not covered by assets currently held in accounts (called trust funds) in the US Treasury.[13] These assets are collected through payroll taxes as well as investment income on specially issued U.S. Treasury securities.[14,15]

It is important to note, however, that the term "trust fund" does not hold the same meaning as a private sector trust fund. In a private sector trust fund, assets are held for a person or organization. When the Social Security and Medicare trust funds redeem the special issue U.S. Treasury securities, the securities are paid for by tax increases, more borrowing, and/or taking funds from other federal programs. The federal government admitted this in the FY 2000 Budget Report:

> "These balances are available to finance future benefit payments and other trust fund expenditures–but only in a bookkeeping sense. …They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury, that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures."[16]

Social Security and Medicare accounts, unlike an Individual Retirement Account or a Health Savings Account, are simply records of tax payments and contain no funds.
To cover these unfunded obligations, the federal government may increase taxes, pressure the Federal Reserve to buy treasury debt with newly created money, or (most likely) finance these obligations with more debt, or some combination of the three.

The unfunded obligations dwarf the current national debt: Social Security currently has $22.4 trillion in unfunded obligations and Medicare has $52.8 trillion.[17,18] With an additional $78.2 trillion in unfunded obligations on top of the $34 trillion and growing national debt, as a result future generations of taxpayers will be faced with large tax burdens and fewer policy options.

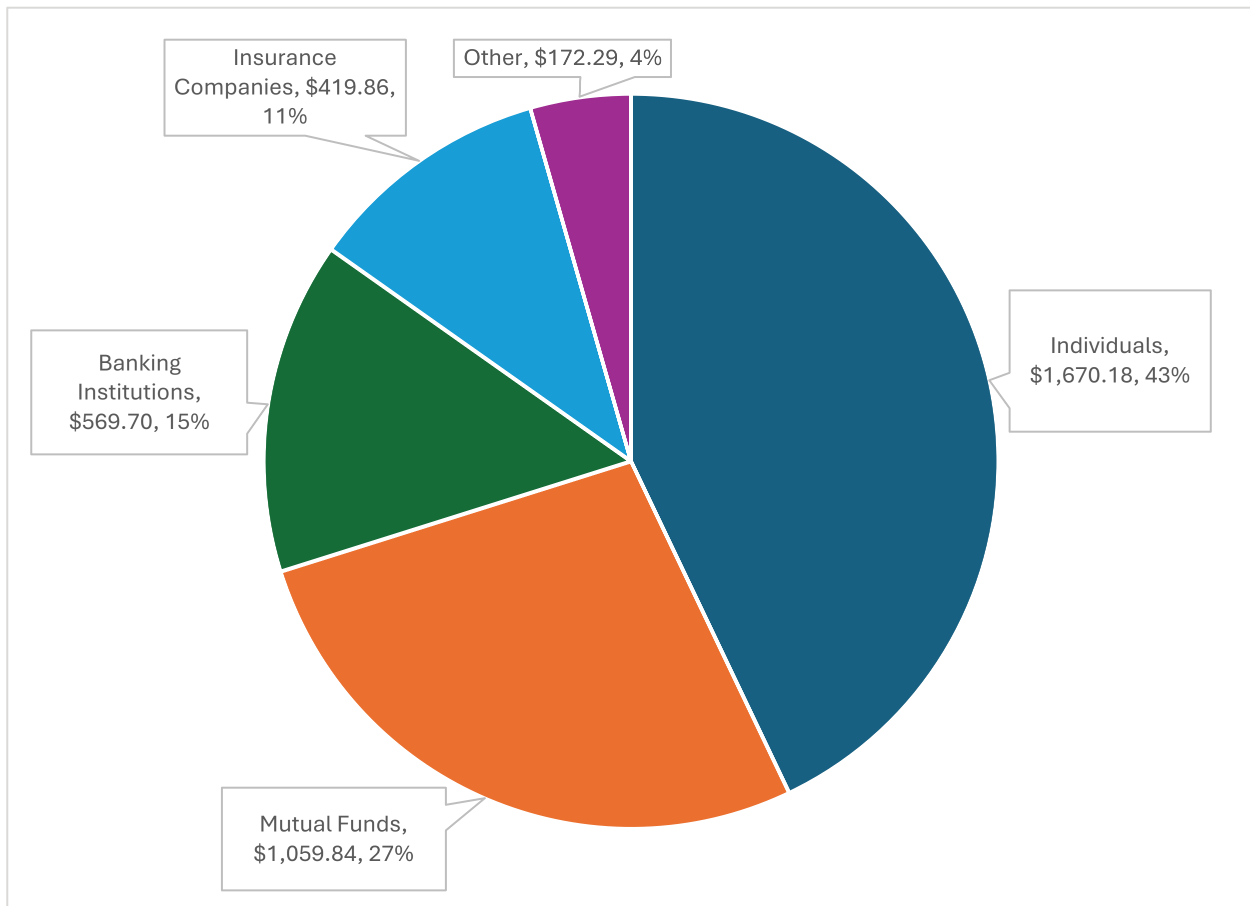
STATE AND LOCAL GOVERNMENT DEBT

Much like the public debt at the federal level, state and local governments also borrow to spend now and pay in the future. Like the federal government there are two types of debt to consider: bonded obligations and unfunded liabilities. Understanding these two types of debt and how they are measured will help understand the true cost to taxpayers, especially future generations. Further exacerbating these issues, state and local governments receive transfer payments from the federal government encouraging them to engage in increased spending and fiscal responsibility.[19] [20]

Bonded obligations are the debt we commonly associate with "public debt." States and municipalities issue bonds for various purposes, bond investors purchase the bonds, and the state or local government pays the bond investors back with interest using taxpayer dollars. Currently, the Securities Industry and Financial Markets Association (SIFMA) calculates that state and local governments have a total of $4 trillion (about $12,000 per person in the US) in outstanding bonded obligations.

Municipal bonds, sometimes called "Munis," draw a less-diverse set of investors than treasury notes but attract investors because they are often tax-exempt and are generally considered a lower-risk investment compared to stocks and corporate bonds.[21]

Figure 5: Who Owns State and Municipal Debt?



Source: "US Municipal Bond Statistics." Securities Industry and Financial Markets Association. Updated May 3, 2024

Another potential risk is when state and local governments fail to make payments (known as default). As state and local government debt grows, confidence in the ability to repay diminishes. Like the federal government, the lack of confidence is reflected in lowering credit ratings and higher borrowing costs.

In addition to public debt, states are heavily dependent on federal funds. The average state gets 38 percent of its total spending funded by the federal government.[22] The average local government gets 36 percent of its revenue from federal and state programs.[23] As policymakers at the federal level make cuts to state and local governments, state and local policymakers are faced with their own difficult choices of raising taxes and cutting spending. Many state and local governments will face default as spending growth rapidly outpaces tax revenue growth.[24] At the state and local level, it is much easier for taxpayers to vote with their feet and leave a state or municipality in default. The mass exodus, however, will leave a heavier tax burden on those residents who remain.

WHAT'S NOT INCLUDED IN STATE AND LOCAL GOVERNMENT DEBT?

In addition to the $4 trillion in bonded obligations, state and local governments also have unfunded liabilities from promised benefits to retired public employees.

A liability for a public pension or other post-employment benefit (OPEB) plan is a benefit to public employees (such as a pension or retiree health insurance) that is expected to be paid out when that public employee retires. When benefit plan assets (made up of contributions from employees, taxpayer dollars, and investment returns) are less than total promised benefits, the remaining promised benefits are considered unfunded liabilities. Determining how much these unfunded liabilities are worth is more difficult than determining total bonded obligations.

To determine whether or not a benefit plan has unfunded liabilities, one must calculate the present value of the total liabilities. The present value shows the value today of those promised benefits in the future, which depends on what economists refer to as a discount rate.[25] The higher the discount rate, the lower the present value and vice versa. The present value of those promised benefits is also sensitive to discount rate changes. Even if the discount rate changes by fractions of a percentage point, the present value of unfunded liabilities could change by millions of dollars.

Current government accounting standards are fairly lenient, using a discount rate that is closer to the rate of return on a retirement plan's investment portfolio.[26] Many economists have pushed back against these lenient standards. They argue that using a low discount rate (such as the yield curve on a US Treasury note) would be more accurate because the low discount rate would reflect the strong legal protections on these promised benefits. If governments used a low discount rate, though, the present value of promised benefits would be billions of dollars greater than currently stated. Larger unfunded liabilities would mean governments would have to raise taxes and cut spending to fulfill these promised benefits, incurring the wrath of voters in the next election.

For OPEB plans such as retiree health insurance, legal protections vary, but it is safe to assume that a state should and will be expected to keep the promises it made to public employees.[27] The disagreement over discount rates means that unfunded pension liability estimates range from $1.35 trillion (around $4,200 per person) using government accounting assumptions, to $6.96 trillion (or around $21,000 per person in the US) using a risk-free discount rate.[28,29] Unfunded OPEB liabilities range from $655 billion (about $2,000

per person in the US) using government accounting assumptions to $1.14 trillion (about $3,500 per person) using a risk-free discount rate.[30]

Taken together, bonded debt and unfunded liabilities represent real future costs to state and local budgets, as well as likely future tax increases to cover them.

NO, WE DO NOT "OWE IT TO OURSELVES"!

In talking about public debt, Nobel Prize-winning economist-turned-pundit Paul Krugman has often repeated the claim that "Debt is money we owe to ourselves."[31] He argues that most of the borrowing comes from the Federal Reserve and domestic investors.

In making such a claim, while technically correct about the large categories of lenders, Krugman makes a key error by ignoring who pays the cost of public debt. Nobel Prize-winning economist James Buchanan made clear this point and identified three groups of people involved in the Public Debt:

1. Taxpayers in the present. Taxpayers get to enjoy increases in public spending without the increase in taxation.
2. Bond investors. Investors purchase bonds from the government but can expect to be repaid with interest.
3. Future generations. Future taxpayers must make "genuine sacrifices" to their income when paying the increased taxes used to service the matured debt. These future taxpayers have no say as to whether debt should be issued, because they are either too young to vote or have not been born yet.[32]

Even in cases where public debt is held like Krugman suggests it is, the taxpayers from future generations who will pay the public debt are distinct from present taxpayers and bond investors. In cases where public debt is employed to paper over budget deficit or to finance spending programs for political reasons, future taxpayers will have to pay more in taxes but have few improvements to public services to show for it.

For Fiscal Year 2024 those payments will total $870 billion and keep growing. These payments alone represent a $2,400 tax bill for every man, woman, and child in the United States in 2024 alone.

Buchanan noted that, like all other actions in life, taking on debt has an opportunity cost. Using debt to finance current spending is, "in effect, chopping up the apple trees for firewood, thereby reducing the yield of the orchard forever."[33]

Growing public debt necessitates debt-service payments that may crowd out other areas of spending. As interest rates rise, debt-service payments grow, and interest groups will become increasingly aggressive in advocating that their preferred spending programs do not face cuts, but receive priority treatment.

If debt service payments become too expensive, spending cuts to other programs become inevitable. If this occurs at the state and local level, government officials may seek funding from the federal government to cover budget deficits, increasing federal spending and, likely, debt. If this occurs at the national level, the federal government will have to cut spending to compensate for what is sent to state and local governments, resulting in massive budget deficits at the state and local levels and potentially triggering fiscal crises among distressed governments.

More insidious is the reality that debt payments take capital out of the private sector, and as a result decrease private investment. When private investment decreases, so does production leading to slower economic growth, ultimately making everyone less prosperous.

Part 2: The Future and Public Debt

For all levels of government, federal, state, and local, raising taxes and/or cutting spending can help slow the growth of debt and pay down existing obligations. Both of those actions are politically unpopular, and politicians are hesitant to undertake them. The reticence is not surprising, because increased taxes and spending cuts are felt directly by the very voters politicians rely on to be reelected. When taxes are raised, voters pay more for government services, and when spending is cut fewer public services are provided. Inevitably, elected officials will face voter backlash. On the other hand, elected officials can better their reelection prospects by promising tax cuts and generous public spending programs (often financed by taking on more debt), and push the costs into the future generations who will pay the debt, but cannot yet vote the politician out.

Exploring the possible outcomes when federal, state, and local governments default on their debts helps shed light on what can happen when elected officials will not or do not make difficult policy choices to pay down debt.

WHAT HAPPENS WHEN A LOCAL GOVERNMENT CANNOT PAY ITS DEBTS?

When local governments struggle to pay their debts, they are faced with raising taxes, cutting spending, or (their preferred option) asking the state or federal government for additional money. On average, local governments get 37 percent of their funding from transfers from federal and state governments.[34] Receiving additional aid from the state and federal government, especially aid to deal with accrued debt, benefits the residents of one community by making all taxpayers across the state and the nation pay for those benefits.

Unlike the federal government or the states, when a local government fails to pay its debts, it also has the option to declare bankruptcy under Chapter 9 of the Bankruptcy Code.[35] The purpose of Chapter 9 is to allow municipalities to restructure their debts and establish a payment plan with creditors, while still providing public services to residents.

Access to Chapter 9 Bankruptcy, however, does not mean a municipal bankruptcy is painless. Detroit's bankruptcy in 2013, the largest municipal bankruptcy filing in US history, the largest creditors were the retired public employees. Detroit had not properly funded the public pension system, despite a state constitutional requirement to do so.[36] The negotiated bankruptcy and the prosecution of numerous city officials on corruption charges, were not the final negative impacts on Detroit residents.[37] Eleven years later, residents continue to feel the effects of the bankruptcy and the conditions that created it. Detroit's median household income ($37,761) and per-capita income ($22,861) are less than half of the national average.[38] The poverty rate is 31.5 percent, more than double the national average.[39] Public services have similarly not improved, with police and first responders facing budget crunches, despite a crime rate that remains more than double the national average.[40] The most revealing trend is that Detroit is also rapidly losing population, seeing a steady decline in the city population since 2010, and an accelerated decline after the 2013 bankruptcy.[41]

Detroit has not improved its long-run spending posture and is poised for a return to significant public debt issues. In 2022, city officials projected an operating budget shortfall by 2027, even with the state and foundations funding pensions.[42]

While bankruptcy is an option for local governments that cannot pay their debt, it does not guarantee improved performance after bankruptcy.

WHAT HAPPENS WHEN A STATE GOVERNMENT CANNOT PAY ITS DEBTS?

Just like local governments, states also have the option of raising taxes, cutting spending, and receiving transfer payments, and the same incentives apply. Politicians that raise taxes or cut services risk alienating the voters they rely on for reelection.

One often-suggested possible option for cutting spending to cut transfer payments to local governments and thereby free up funds. As attractive as that option looks, it is limited in scope. Aid to local governments often comes in the form of "pass through" grants, where the federal government sends money to state governments, who then are obligated disburse the funds among localities.[43] If the state cuts federal aid to local governments to cover its own spending, it could face backlash and requirements to pay back funds for not properly complying with the terms of the federal grant.

The reality is that states and municipalities face fiscal crises differently, and not just because of differences in size and scope of government. One key distinction is bankruptcy. State governments legally cannot declare bankruptcy, while municipalities can.[44] While state governments cannot declare bankruptcy, it is still possible (though rare) for them to default on their debts and to leave creditors to sue under US Constitution Contracts Clause to try to recover what is owed.[45]

The last time a state defaulted on its debt was Arkansas in 1933, when it failed to pay bondholders for debt issued for highways.[46] After a failed attempt to declare sovereign immunity and shed its losses, Arkansas was required to pay many of its creditors back in full. The result was a smaller pool of funds available for public services. If the state had failed to negotiate a deal with its creditors, the federal Public Works Administration threatened to suspend all loans to the state until its bond refunding issues were resolved.[47]

More recently, the state of Illinois has teetered on the edge of default for the past several years. In April 2020, following pandemic-related lockdowns and a subsequent market crash, the Illinois State Senate President wrote to Congress begging for a bailout to cover pensions and city budgets.[48] Shortly after, Illinois received federal dollars from the CARES Act, as well as loans from the Federal Reserve Municipal Liquidity Facility.[49] The loans from the Municipal Liquidity Facility were provided to the state at below-market interest rates.[50] The injection of funds from the federal coronavirus spending programs have helped keep Illinois afloat, but there are no signs of structural change to its budget policy.[51] Since receiving federal funds from these various programs effectively bailing it out, Illinois has not made any improvements to its fiscal condition, boasting the worst credit rating among the 50 states.[52]

Another recent example is highlighted by the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) in 2016, Puerto Rico was set on the path to restructuring its debt.[53] In August 2017, all beneficiaries of the Employees' Retirement System (ERS)were put into the defined contribution plan, but it was too little, too late. Puerto Rico was still unable to pay its pension obligations.

According to the Plan of Adjustment, any retiree (either in the ERS, the Judicial Retirement System, or the Teachers' Retirement System) earning over $1,200 per month will see an 8.5-percent reduction in benefit payments and a separate, independent pension reserve trust will be established specifically to fund pension obligations for current retirees.[54]

In addition, bondholders of ERS bond claims (some of the $35 billion in "debt and other claims" being reduced) will see an 87-percent reduction. These pension obligation bonds did not save the ERS from long-term unfunded liabilities and proved once again to be a poor investment for bond holders.[55]

In March 2022, a federal court confirmed a plan to reduce Puerto Rico's debt by 80 percent.[56] David Skeel, Chairman of the FOMB and Professor of Corporate Law at the University of Pennsylvania Carey Law School, stated that the primary goal was to prevent this from happening again in Puerto Rico.[57] Under the bankruptcy plan, Puerto Rico currently has a borrowing limit of $1.15 billion, about 8 percent of commonwealth revenues, excluding federal aid.[58] In addition, a Contingent Value Instrument was implemented to connect bondholder payouts to sales tax revenues. Thus, the more Puerto Rico's economy improves, the more money bondholders receive, but bondholders will almost certainly still take a large reduction in the value of their bonds.[59]

WHAT HAPPENS WHEN THE FEDERAL GOVERNMENT CANNOT PAY ITS DEBTS?

When the federal government cannot pay its debts, it is faced with three somewhat practical choices: raise taxes, print money, cut spending, or some combination, and one wildly impractical one: default. The potential impact of default is impossible to estimate, because the costs would be catastrophic. Most economists and policy experts discount this possibility and argue that the practical alternatives would almost certainly forestall a true default.

The option of default, however unlikely, is worth exploring to understand its implications, and why politicians cut deals using borrowing, spending, cuts, and tax increases to avoid it. Tyler Cowen, an economist at George Mason University, has referred to a federal default as "the end of the world."[60] If investors lose faith in the long-term financial stability of the US government, that lack of faith, Cowen argues, could have ripple effects across the economy, including decline of long-term private investment. This is because faith in American corporations will decline in tandem with the decline in faith in the US government's ability to keep its promises. Simultaneously because the US dollar is the primary global reserve currency, there is no entity that can bail out the US federal government. Peter C. Earle, our colleague at AIER, points out, that in such a circumstance the US will be faced with "unprecedented levels of taxation, a browbeaten dollar, and unwelcome yet unavoidable foreign influence in domestic affairs."[61]

The best possible course is for the federal government to cut spending and create a surplus that can be used to make debt payments. Politicians are unlikely to cut spending, because various interest groups impact their ability to get reelected if they fail to support donor-favored spending. Because every group thinks its spending is essential, cutting overall spending becomes politically improbable. Elected officials have a strong incentive to cater to those interest groups that benefit from spending, rather than reduce spending to pay down debt. This reality means that as the national debt continues to grow, lawmakers in Washington face the growing temptation to lean on the Federal Reserve to monetize the debt.[62]

Monetizing the debt simply means printed money to cover that debt, the result of which is a decrease in the value of the dollar (inflation). Such an action could lead the United States into precarious economic conditions, not unlike the "Lost Decade" that Japan faced from 1991-2001, and the continued issues its economy has faced. Japan had experienced rapid economic growth in the 1980s but "fell into a prolonged slump marked by persistent, high unemployment, low growth rates, and erratic monetary policy."[63]

The result of this prolonged slump has been a cycle of continually issuing bonds to cover budget deficits and using its central bank to print money and keep interest rates on the debt artificially low. Life became less affordable for Japanese citizens, and future generations are expected to pick up the tab.

While not a perfect comparison (as demand for the dollar and US Treasury notes are greater than Japanese Yen and Japanese government bonds) the effects would likely be similar. Economist Hiroshi Yoshida notes that in both the US and Japan, "not enough people stand up for future generations when it comes to fiscal policy."[64]

Predicting exactly when the US federal government will be unable to pay its debts is, as our colleague Peter Earle notes, a "....futile endeavor of predicting fiscal tipping points."[65] The consequences, however, of the seemingly unending debt are not difficult to predict: economic stagnation, higher prices, reduced economic growth, and myriad other negative consequences will eventually follow if the growing debt is not dealt with.

Part 3: What Can Be Done About Public Debt?

RAISING TAXES WILL NOT FIX THE PROBLEM

The usual view is that to pay the national debt taxes will simply have to be raised but doing so, according to research on tax proposals currently on the table by Brian Reidl at the Manhattan Institute, a maximum of 2.1 percent of GDP could be raised (about $7 trillion over the next decade).[66] Another estimate from the Tax Foundation finds that recent proposed tax increases in the President's FY 2025 budget would raise $2.2 trillion from tax increases at the cost of decreasing long-run GDP by 2.2 percent, depressing long-run wages by 1.6 percent, and destroying 788,000 full-time jobs.[67] That analysis found that deficit growth, along with debt growth, would still occur due to current spending trajectories.[68] Without any spending reforms, this revenue, raised at disastrous cost, will barely make a dent in the growing national debt.

Despite this reality there are calls from some politicians and academics to raise taxes as a solution, but In Fiscal Year 2023, the Federal Government took in $4.4 trillion in tax revenue and simply.[69] increasing that amount will not solve the problem. Increasing tax burdens adds greater strain on Americans, slows growth, and incentivize government officials to just keep spending.

William Graham Sumner's "The Forgotten Man" describes government taxation and spending is as the process where person A notices a wrongdoing from "which X is suffering," and A consults person B about what should be done. A and B agree to pass a law to decide "what A, B, and C shall do for X" without ever consulting person C. Person C is the forgotten man. Sumner comments, "He works, he votes, generally he prays—but he always pays..."[70] Milton and Rose Friedman echo a similar sentiment in Free to Choose, saying "your spending someone else's money on still another person...You have little incentive either to economize or try to get your guest the lunch that he will value most highly."[71]

The reality is that a little more than half of all tax revenue comes from individual income taxes.[72] Further investigation shows that the top 1% (filers earning at least $682,577) pay 26.3 percent of all income taxes.[73] The top 10% (filers earning at least $169,000) pay 52.61 percent of all income taxes.[74] The top 50% (filers making at least $46,637) pay just under 90 percent of all income taxes.[75] These taxes come at a cost of the next highest valued use of those tax dollars. Like all taxes, these taxes create distortive effects. Any money taken in taxes comes at the cost of private investment and consumption, hampering economic growth and leading to lower standards of living for us all.

TAME SPENDING TO ALLEVIATE GOVERNMENT DEBT

At the root of large government debt is unsustainable spending. By re-prioritizing spending to only the core functions of government and reducing spending overall, public debt can be brought under control. None of the potential solutions offered here are a panacea and each has its own set of trade-offs. In the 2024 Financial Report of the United States Government, the federal government even admitted that "current policy under this report's assumptions is not sustainable and must ultimately change."[76]

PRIORITY-BASED BUDGETING

Ideally, a complete overhaul of the budgeting process would help rein in spending and debt. Instead of the status quo of automatic increases on mandatory spending, budgeting would focus on the core, constitutional functions of the federal government. When drafting a budget, we and others suggest that policymakers must be able to answer five key budget questions:[77]

- What is the proper role of government?
- What are the essential services the government must provide to fulfill its purpose?
- How will we know if the government is doing a good job?
- What should these essential services cost?
- When cuts must be made, how will they be properly prioritized?

A major trade-off of this approach is that priority-based budgeting simply takes longer and requires more action by lawmakers than the current method. The process is also susceptible to all of the knowledge and incentive problems faced by current budget processes. Policymakers do not have the necessary knowledge and information to effectively allocate scarce resources. Strict budgeting also depends upon having policymakers (both elected and unelected) that are willing to limit government to its proper role. Government officials holding themselves accountable is an unrealistic assumption , and as a result even the weak limits that explicit priority-based budgeting policies are necessary. In fact, priority-based budgeting must be paired with another institutional constraint (like a constitutional tax and expenditure limit) to ensure accountability. Interest groups can effectively push for desired policy proposals than the wider, diffused public, with the result that the budget process is likely to fall prey to spending programs that concentrate benefits for these interest groups and disperse the costs among the population at large. Without strong institutional constraints, priority-based budgeting at any level of government can easily fall apart.

CONSTITUTIONAL CONSTRAINTS TO REIN IN BUDGETS

When looking at the possibility of a balanced budget amendment for the federal government, James Buchanan wrote, "Restoration [of a balanced-budget rule] will require a constitutional rule that will become legally as well as morally binding, a rule that is explicitly written into the constitutional document of the United States."[78] Recent research has also found that the need for strong balanced-budget requirements are much stronger than when Buchanan first urged them.[79] The most effective balanced budget rules, however, are ones that are constitutionally binding, apply to the entire federal budget, and are permanent. Even strict plans must have some flexibility, such as tying targets or limits to multiyear periods, and carefully constructing emergency provisions (in case of war).[80]

In addition to balanced-budget amendments, the federal government can also apply a "debt brake," such as the one in Switzerland. In 2001, 85 percent of voters in Switzerland approved an initiative that requires government spending to keep pace with revenue and limits spending growth to average revenue growth over a multiyear period.[81] The majority of the national budget must be balanced each year and adjusts over the course of the business cycle. This policy is called a "debt brake" because spending must be paid for upfront.[82] The government cannot issue debt to cover budget deficits. This brake does not totally ban the government from issuing debt, but it does slow the growth of debt and shrink the debt. Since its enactment, Swiss Central government debt as a percentage of GDP has declined. From 2020-2021, while the US national debt-to-GDP ratio was growing, the Swiss debt hovered around 20 percent.[83]

This Swiss debt brake, however, owes credit to national tax rates set by the Swiss constitution, which require a double-majority referendum to change. When combined with strong fiscal and monetary rules, a debt brake could feasibly help slow spending growth and debt growth.[84]

A BRAC COMMISSION FOR THE FEDERAL BUDGET

The Base Realignment and Closure (BRAC) Commission was an independent commission that evaluated military installations recommending closures and realignments based upon certain criteria.[85] Politicians, whose goal is to be reelected, have an incentive to support spending increases and avoid spending cuts to their district, in order to court voters. Bureaucrats measure success based on the number of people working under them and the size of their discretionary budgets.[86] The best way for a bureaucrat to be successful is to support spending increases for his or her agency. The key benefit of a BRAC commission (whether for spending on military bases or managing the national debt) is that it mitigates the incentive problems facing politicians and bureaucrats by requiring "silent approval."[87] Instead of a member of congress going on record in support of spending cuts (which will negatively impact reelection prospects), the spending cuts are enacted so long as the member of congress does nothing. Instead they must voice their disapproval to prevent spending cuts.[88]

While not perfect, the BRAC process has allowed the federal government to save money and focus on key defense priorities.[89] The independent commission would be the ones to draft a list of recommended cuts and realignments instead of members of Congress (swayed by nonfinancial interests). This commission would then send the recommendation list to the Secretary of Defense and the President for approval. If approved, the list would then be sent to Congress, where members of the House of Representatives and the Senate must pass a joint resolution rejecting the recommendations within a specific timeframe, otherwise the BRAC recommendations automatically take effect (also known as "silent approval").

Lawmakers from both parties in the House of Representatives have proposed legislation supporting a BRAC-style fiscal commission to lower the national debt. If passed, the commission would engage in budget reforms with the goal of stabilizing the debt-to-GDP ratio to no more than 100 percent within 10 years. Economist Romina Boccia notes that, without certain constraints, the commission would be rendered ineffective.[90] These constraints include the "silent approval" mechanism, as well as requiring the fiscal commission to review both mandatory and discretionary spending.

By applying an effective BRAC process to the budget, the federal government could fix the budget while minimizing the damage from the incentive problems facing elected officials and bureaucrats.

THE INTERACTION BETWEEN FEDERAL, STATE, AND LOCAL GOVERNMENTS

Reining in federal spending will inevitably mean reducing federal transfer payments to state and local governments, which would have significant budget impacts and — if they don't respond with similar cuts in spending — an increase in local and state debt.

State and local governments should take preemptive actions to limit their dependence on federal funds. The first step would be to track how much federal money is coming into state and local budgets and the specific areas of government funded by federal dollars. State governments can require state agencies to seek legislative approval before applying to federal programs to ensure that agencies do not "double dip" and receive funding from the same federal agency. For example, two agencies in the same state might, for example, double dip into federal Pre-K subsidies, because those can be earmarked as 'education' and also as 'childcare.' Furthermore, state legislatures can require state agencies to have an emergency plan in place in case of a 5-25 percent cut in funding (simulating a cut in federal funds). These strategies have worked in part for Utah as part of its "Financial Ready Utah" plan, enacted in the wake of the Great Recession.[91]

Further if a state is a Dillion Rule state (local governments can only legislate what the state government has decreed), it is possible for the state to impose similar restrictions on local governments seeking funding from federal programs.[92] If a state is a Home Rule state (local governments have the authority to make broad legislative decisions not addressed by the state), the state will have less power to restrict local government access to federal programs, and local governments would have to do it themselves.[93]

When it comes to government spending that is not funded by federal transfer payments, state and local governments have a wide variety of additional options to restrict the growth of spending and, ultimately, debt.

FISCAL RULES FOR STATE AND LOCAL GOVERNMENTS

The purpose of a spending limit is to provide fiscal discipline during strong periods of revenue growth, and to avoid creating a structural deficit by overspending. This two-pronged policy makes state budgets more resilient in the face of unanticipated expenses. When properly designed and implemented, tax and expenditure limitations (TELs) can be effective in constraining the growth of government spending and stabilizing budgets over the business cycle.

Such a policy has been in effect in Colorado since 1992: The Taxpayer's Bill of Rights (TABOR) amendment to the Colorado Constitution.[94] TABOR has revenue and expenditure limitations that apply to state and local governments. The revenue limitation applies to all tax revenue, prevents new taxes and fees, and can

only be overridden by popular vote. Expenditures are limited to revenue from the previous year, plus the rate of population growth, plus inflation. Any revenue above this limitation must be refunded with interest to Colorado citizens.

TELs are much more effective when incorporated into state constitutions rather than in easily evaded or ignored statutes. The most effective TELs also limit the rate of growth of revenue and expenditures to the sum of inflation plus population growth.[95] If states link TELs to a measure of aggregate economic activity, like personal income, it will be less effective in constraining growth of spending and stabilizing the budget. This is because personal income is a more volatile measurement than the sum of population and inflation growth. In the end, like any other constitutional constraint, a TEL is most effective when it applies to the entire budget.

ADDING A CHAPTER IN THE BANKRUPTCY CODE FOR STATES

Under the current US Bankruptcy Code, state governments cannot declare bankruptcy. Legal Scholar David Skeel has made the case for creating a chapter in the US Bankruptcy Code specifically for state governments. Skeel notes that allowing the states to declare bankruptcy would help provide a clear path for a state in danger of default, and the threat of bankruptcy would give state officials leverage to negotiate state obligations outside of bankruptcy instead of relying on the Contracts Clause[1] to do so.[96]

Economist Veronique de Rugy and legal scholar Todd Zywicki also considered the tradeoffs of allowing states to access the US Bankruptcy Code in the wake of the economic downturn of 2020.[97] They noted that those in favor of creating a Bankruptcy Code disregarded the problem of rent-seeking groups (such as public employee unions) that could lobby for policy changes in the bankruptcy code that favor the rent-seekers at the expense of the general public. In addition, state bankruptcy could easily backfire. If not done properly, de Rugy and Zywicki warn, bankruptcy will allow states to continue spending patterns that put them in bankruptcy in the first place, restarting the cycle with “a clean slate without providing incentives to change the core source of their financial problems…”[98] David Skeel, an American Law Professor who oversaw Puerto Rico’s recent bankruptcy, noted government bankruptcy oversight’s “messiness” in practice.[99] The complexity of the restructuring unfunded liabilities and bonded obligations (some of which is still in the process of restructuring) means that bankruptcy is not a “quick fix” to government fiscal woes.[100]

de Rugy and Zywicki also noted that opponents to allowing states to access the Bankruptcy Code “tend to make the perfect the enemy of the good.”[101] They also recommend proper constraints such as ensuring bankruptcy negotiations apply to all parties (including bond investors and public employee pensions) and requiring bankruptcy judges be selected at random by the clerk of the court instead of from the bankruptcy court where the case is located.[102]

de Rugy and Zywicki note that, while imperfect, allowing states to access the US bankruptcy code (with proper constraints in place) is a preferable alternative to a federal bailout of the state or attempts at declaring sovereign immunity.

Conclusion

Whether at the federal, state, or local level of government, the rate of growth of government debt is unsustainable. Debt growth is fueled primarily by government spending and unfunded liabilities. While there is demand from investors for federal Treasury debt and municipal debt, unsustainable debt will lead to lower credit ratings, higher borrowing costs, and a decline in investors' trust that the government will repay its debts. These growing debt burdens represent tax burdens on future generations and divert private capital away from productive investments and into the public sector. When the federal government can no longer pay its debts, lawmakers in DC will face the temptation to monetize the debt by pressuring the Federal Reserve to pay it off quickly using newly printed money. Otherwise, the federal government will resort to painful spending cuts. When state and local governments cannot pay their debts, they are likely to first seek a bailout from the federal government. If they do not get a bailout, states could attempt to declare sovereign immunity and repudiate their debt, or face painful cuts to promised public pension benefits. Local governments do have access to the US Bankruptcy Code, but as seen with the case of Detroit, bankruptcy does not guarantee a return to fiscal sustainability.

Fortunately, solutions are available for all levels of government. Constitutional rules at all levels of government, such as strong balanced budget amendments, debt brakes, and tax and expenditure limits, can significantly lower spending and slow the growth of government debt. Other alternatives include a BRAC-style fiscal commission to help mitigate politicians' incentives to support spending increases. A bankruptcy option for US states is also another feasible option. All the options listed here would be preferable to a federal bailout of state governments, which would only enable continued fiscal irresponsibility.

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