The Fiscal State of the Nation

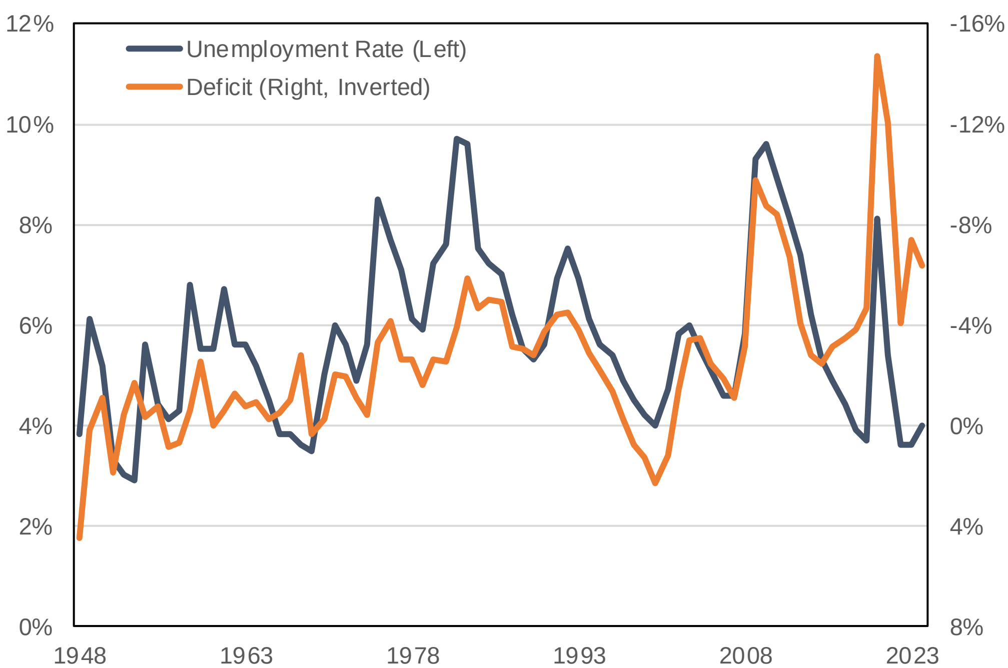
Introduction

Chairman Arrington, Ranking Member Boyle, and members of the Budget Committee thank you for the opportunity to testify on the Fiscal State of the Nation. It is an honor to be back before this committee albeit in a different capacity as I once sat on the other side of the dais as a staffer for then Chairman Paul Ryan. In my current role, I am the Deputy Head of US Policy at Piper Sandler, an investment bank. My job is to conduct macroeconomic research and help our clients, institutional investors, to navigate how US policy affects markets. It is important to note that I am here today representing my own personal views and the comments I express today and in my written testimony do not reflect the views of my employer.

Fiscal Outlook

The current fiscal footing of the US is dramatically out of step with our economic circumstances. Last year, the deficit was 6.4% of GDP and the primary deficit (which excludes interest costs) was 3.3% of GDP. This is unprecedented given the US was neither in recession nor at war. In 2024, the unemployment rate averaged 4%. In all the years going back to 1948, whenever the unemployment rate was below 5% the deficit has averaged 0.5% of GDP. In fact, during those years of low unemployment the US has averaged a primary surplus of 1.1% of GDP.[1] This means the primary deficit is 4.4% of GDP larger than it has been in similar economic circumstances. To put that in context, Social Security outlays amounted to 5% of GDP last year.

FEDERAL DEFICIT (-) AS % GDP VS. UNEMPLOYMENT RATE, 1948 TO 2024

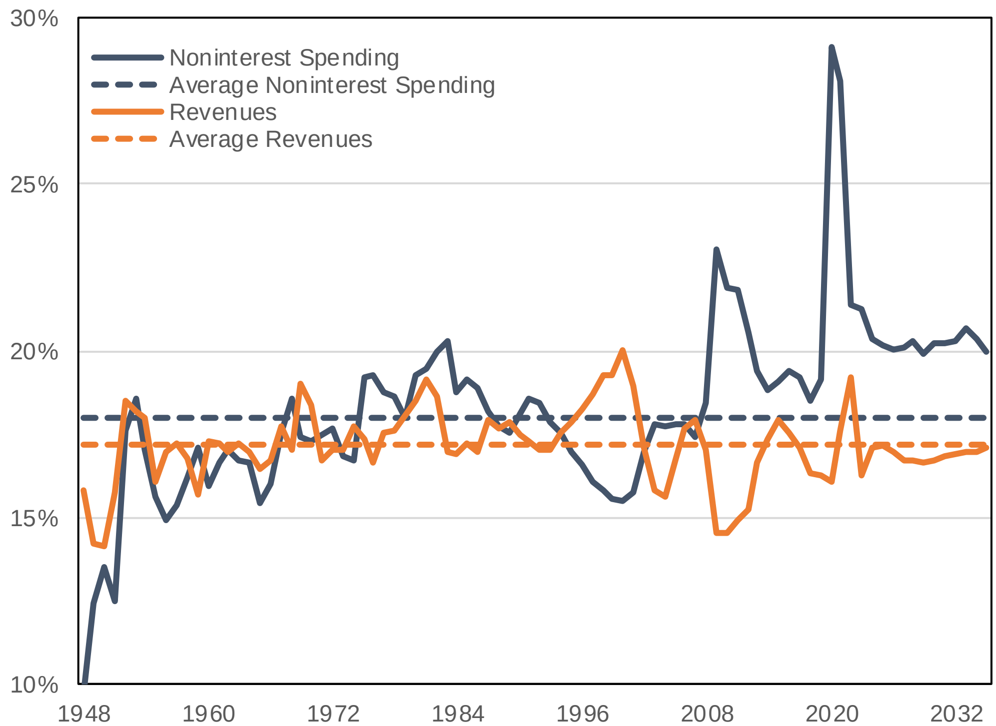


Sources: OMB and BLS.

The primary deficit is not necessarily elevated because of cyclically stimulative policies, instead, the deficit is being driven by structural factors such as the aging of the population, rising health care costs, and expanded eligibility for entitlement programs. As more individuals retire and begin to rely on Social Security and Medicare there is increased structural pressure on budget deficits. As the following chart indicates, noninterest spending has averaged 18% of GDP since 1948. Noninterest spending is currently 20% of GDP and, under CBO's assumptions, will stay at 20% of GDP over the next decade. This is a meaningful increase from the historical average and a departure from recent levels. It was 19.1% of GDP in 2019 before the pandemic and 17.4% of GDP in 2007 before the financial crisis.

In contrast, since 1948 revenues have averaged about 17.2% of GDP. Even after assuming the 2017 tax reforms (known as the Tax Cuts and Jobs Act or TCJA) are fully extended, which is embedded into the chart, revenues will roughly match their historical average over the next decade.[2] In short, from a historical perspective, revenues are normal while spending levels are unusually high.

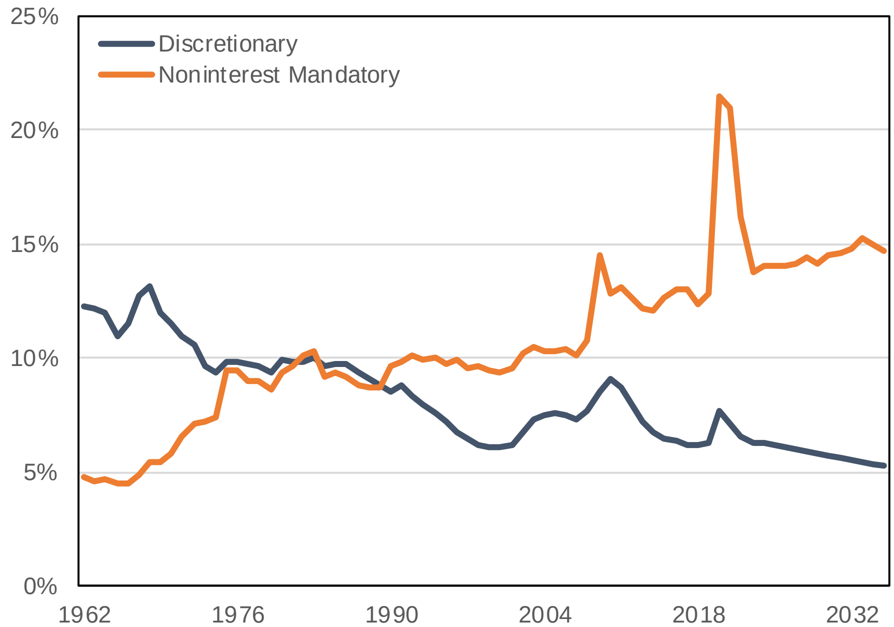
NON INTEREST SPENDING AND REVENUES AS % GDP, 1948 TO 2035



Sources: OMB, CBO, AEI, and BEA. Note: Assumes the full extension of 2017 tax reforms.

The trajectory of noninterest spending is more troubling than it appears. Part of the reason why noninterest spending is able to stay flat over the next decade is because discretionary spending (defense and non-defense) is projected to shrink as a share of GDP. Under the current baseline, defense will shrink to a historic low of 2.4% of GDP. This implies a significant underfunding of our national defense needs. At the same time, noninterest mandatory spending will continue to grow up to about 15% of GDP by the end of the decade. For perspective, noninterest mandatory spending was 10.1% of GDP in 2007 and 12.8% of GDP in 2019 (see the chart below). In prioritizing ways to get our fiscal house in order, mandatory spending is what requires the most urgent attention.

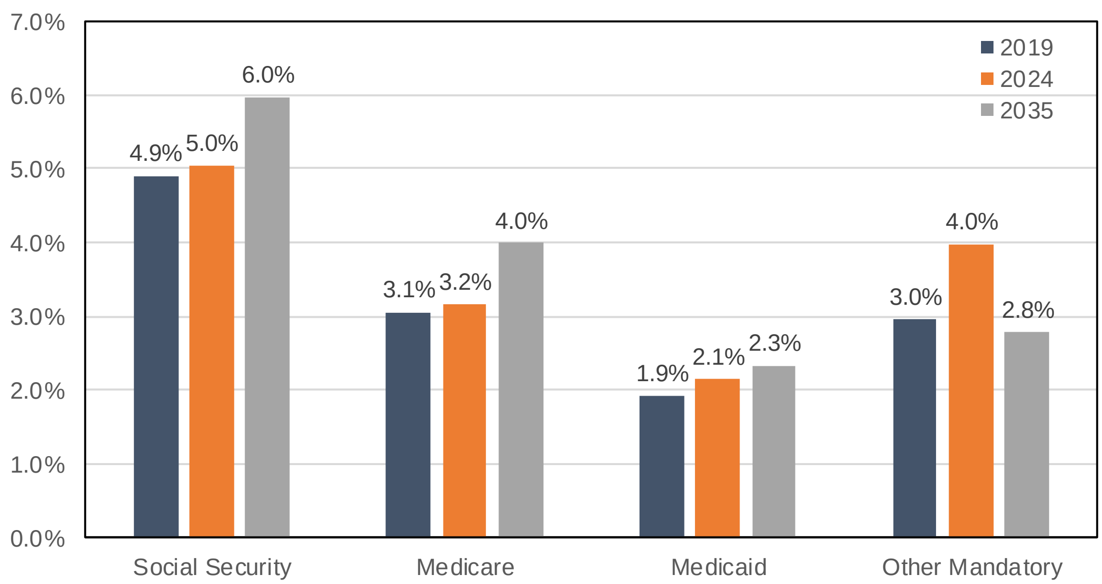
DISCRETIONARY AND MANDATORY SPENDING AS % GDP, 1962 TO 2035



Sources: CBO.

Most of the upward drift in mandatory spending over the next decade will occur in Social Security and Medicare but also to a lesser extent, Medicaid. The remaining net portion of mandatory spending will be roughly constant as a share of GDP relative to 2019.

PORTIONS OF NONINTEREST MANDATORY SPENDING AS % GDP, 2019 VS 2024 VS 2035

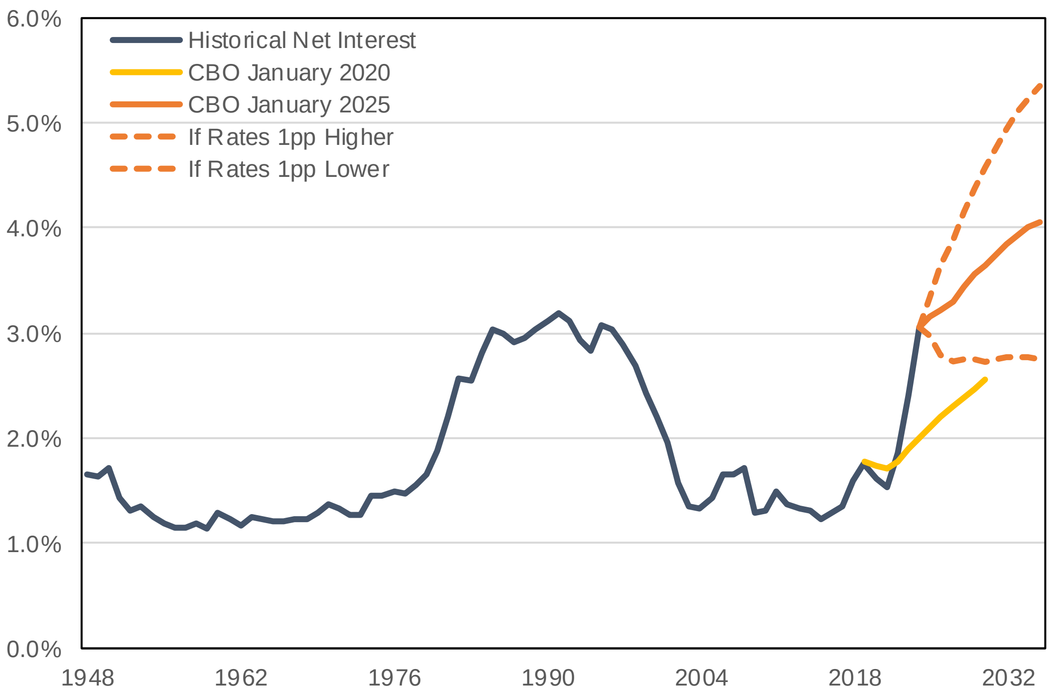


Sources: CBO.

However, noninterest mandatory spending isn't the whole story. Part of what makes the fiscal outlook so concerning is the level of interest costs, its expected trajectory, and the sensitivity of the fiscal outlook to changes in interest rates. Interest costs as a share of GDP have already reached the all-time highs last seen in the 1980s and 1990s when interest rates were far higher. The average interest rate on marketable public debt in 1991 was about 8.4% versus 3.3% today. Interest costs are so large now, despite relatively low interest rates, because the stock of debt is massive. This means any incremental changes in interest rates will be very costly and push the nation's finances further out of balance.

As the chart on below demonstrates, in January 2020 CBO forecasted interest costs would be 2% of GDP in in FY24. Interest costs are now about 3% of GDP. So, interest costs can change quickly when interest rates change. Assuming a current law baseline, which means no new policies, the TCJA expires, no recessions, and a relatively benign interest rate forecast (about 3.9% on the 10-year Treasury), interest costs will rise to unprecedented levels of 4% of GDP by the end of the coming decade. If interest rates are 1 percentage point higher than CBO forecasts in each year over the next decade, interest costs would surge above 5% of GDP. If interest rates are 1 percentage point below their forecast, interest costs would settle at about 2.8% of GDP – effectively matching all-time highs.

NET INTEREST AS % GDP, DIFFERENT SCENARIOS, 1948 TO 2035



Sources: CBO.

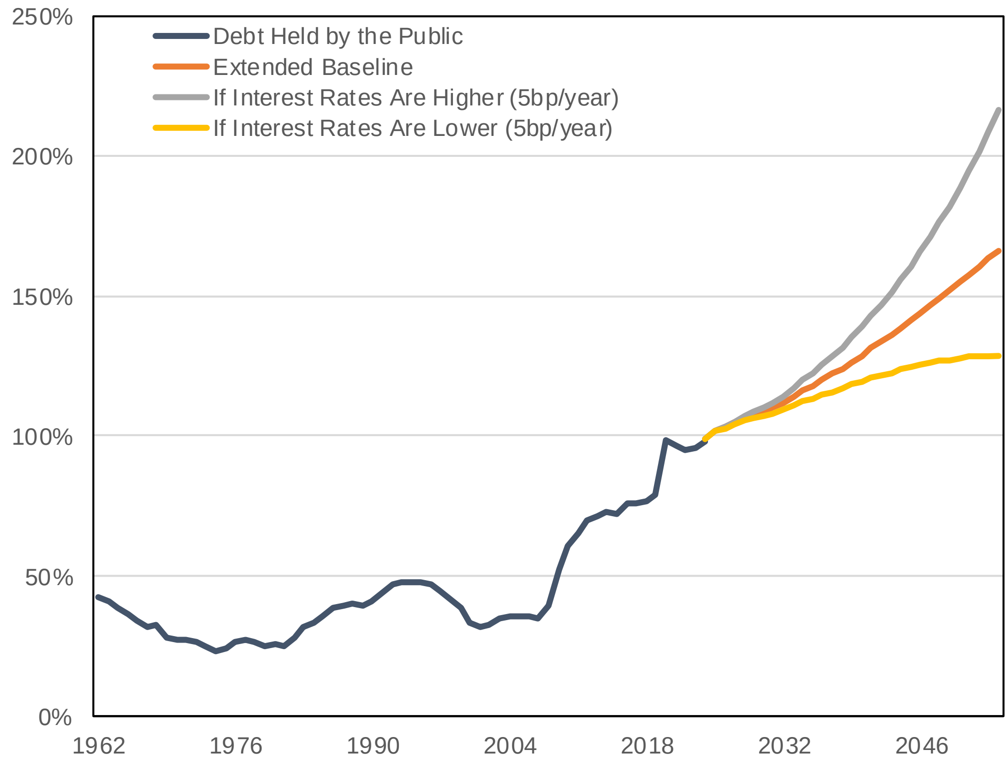
Putting all of these various pieces together, it is clear the US fiscal trajectory is unsustainable. Consider the debt-to-GDP ratio under CBO's long term budget outlook. The debt-to-GDP ratio already sits around 100% and is poised to rise to over 150% by 2050. Again, this assumes no new policies are enacted, interest rates stay low, discretionary spending continues to shrink as a share of GDP, and there are no recessions. These are all questionable assumptions.

It is important to keep in mind that larger deficits and greater debt beget higher interest rates which crowd out private investment. A recent literature review by the CBO finds a one percentage point increase in the debt to GDP ratio increases long-run interest rates by about 2 basis points.[3] Weaker investment means slower economic growth which only further compounds the problem. Every 0.1 percentage point reduction in real GDP growth, if sustained, adds $388 billion to the deficit over a 10-year window.[4] Even small changes in interest rates over time would dramatically increase the debt to GDP ratio (as the chart below makes clear).

The flip side of this coin is that if policymakers get serious about fiscal restraint they can crowd in private investment, boost economic growth, and lower interest rates. It is important that policymakers begin this process as soon as possible because further delay would only make the necessary corrective actions even costlier.

This poor fiscal outlook has been known for many years. We were debating this very topic when I served on the House Budget Committee over one decade ago. In this sense, we are heading towards the most predictable crisis but are doing little to address it.

DEBT-TO-GDP RATIO UNDER CBO'S 2024 EXTENDED BASELINE, UNDER VARIOUS INTEREST RATE ASSUMPTIONS



Sources: CBO.[5]

A Market Perspective

As someone who routinely speaks with institutional investors to field their questions on the US policy outlook, I can offer a few recommendations and comments about the fiscal outlook that reflects the perspective I've gained in interacting with investors.

It's Not Just What Decisions Are Made, It Matters How They Are Made. Avoid Legislating By Crisis. When Fitch downgraded the US credit rating from AAA to AA+ in August of 2023 the announcement noted a combination of factors such as "expected fiscal deterioration" and "erosion of governance." While fiscal deterioration was already widely expected, the new piece of information Fitch reacted to was changes in governance. To quote the entire passage:

> "In Fitch's view, there has been a steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters, notwithstanding the June bipartisan agreement to suspend the debt limit until January 2025. The repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management. In addition, the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process. These factors, along with several economic shocks as well as tax cuts and new spending initiatives, have contributed to successive debt increases over the last decade. Additionally, there has been only limited progress in tackling medium-term challenges related to rising social security and Medicare costs due to an aging population."[6]

In other words, ongoing fiscal deterioration is widely understood. But an inability to govern without brinksmanship over routine funding bills and necessary debt limit increases, coupled with an absence of a plan to address the debt over the medium term (or seemingly even agreement on that objective) is cause for concern.

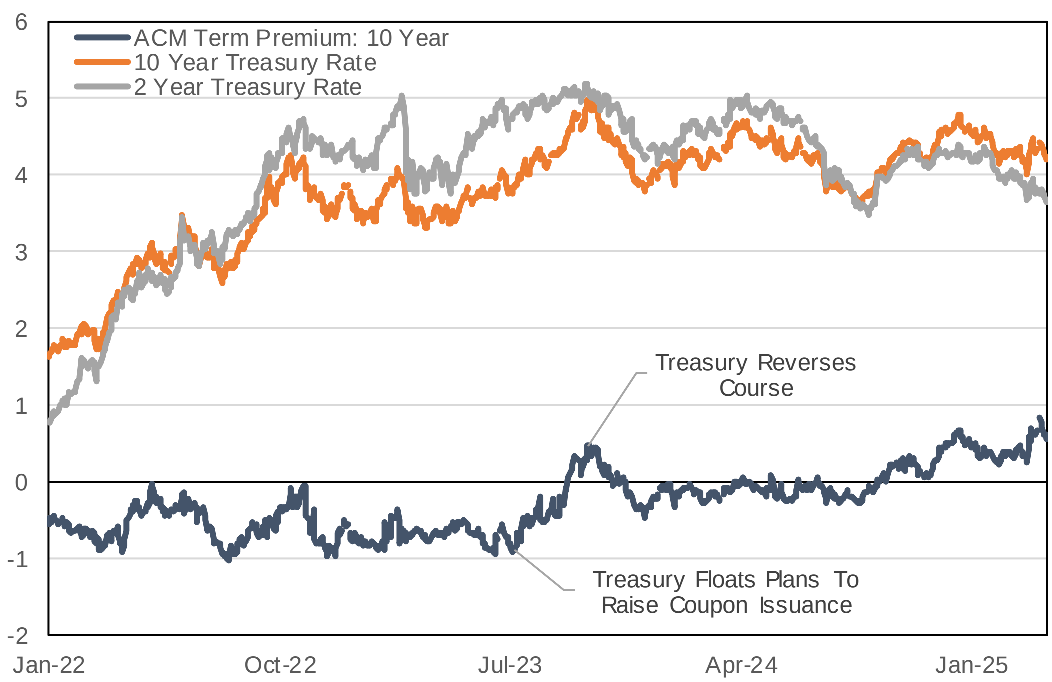
Market Sentiment Can Shift Quickly And Decisively. Minimize Policy Uncertainty And Conserve Fiscal Space. There is a saying that economies "go broke slowly, then suddenly." Recent events should clearly signal to policymakers that they must tread carefully on fiscal matters as market sentiment can shift rapidly. Amidst market turmoil in April, one particularly concerning development was that as growth expectations, equities, and the dollar declined, long term interest rates rose (albeit temporarily). Ordinarily, one might expect long term interest rates to decline as well (moving in the same direction as other variables) as lower long term rates would reflect underlying expectations for weaker growth and thus lower short-term interest rates. But that didn't happen.

Part of the reason long term interest rates rose during that episode had to do with investors around the world reducing exposure to US assets. Of course, other factors played a role as well such as derisking from longer term bonds (towards shorter duration securities) and the unwinding of the so-called "basis trade."[7] But in order to prevent the fiscal outlook from getting worse, we simply cannot afford policies, or even policy uncertainty itself, to make US assets less desirable. Acting sooner rather than later to get our fiscal house in order will help to conserve fiscal space and increase the margin for error in the event that market conditions are unfavorable.

Interest Rates Are Sensitive Not Just To How Much Debt Is Issued, But How It Is Issued And Who Is Buying It. The previous points should make it clear that maintaining the attractiveness of US assets is critical. If there is robust demand for US treasuries it helps to put downward pressure on interest rates. A related issue is not just who buys treasuries or how much debt is issued, but how it is issued. A recent episode in August to October 2023 comes to mind. Over that period, the 10-year treasury rate rose from about 4% to 5% - a level that, if sustained, would be problematic for the budget outlook and equities. As the following chart indicates, the run up in long term interest rates occurred at a time in which the 2-year Treasury rate barely increased. The shift up in rates coincided with guidance from the Treasury Department in early August that it would soon be increasing issuance of long-term bonds. As markets digested the expected increase in Treasury supply, it put upward pressure on the term premium which is the excess return required to hold treasuries (this can come in the form of duration or inflation risk).

Over the coming months and years, the Treasury Department may shift away from bill issuance and relatively more towards longer term debt to maintain a prudent bills share (around 15% to 20% of outstanding debt). Because we generally tend to finance our debt in periods of economic stress through bill issuance, running an elevated bills share indefinitely raises the prospect that the bills share will ratchet up higher in the event of another downturn. This will leave the US exposed to debt rolling over and being financed at even higher rates. Terming out the debt will eventually be necessary but will put upward pressure on the long end of the curve. Fiscal restraint can help blunt this inevitable impact on rates.

SELECT INTEREST RATES AND THEIR COMPONENTS, 2022 TO PRESENT



Sources: Federal Reserve and FRBNY.

Investors Are Not Fooled By Baseline Games, Manipulating Budget Windows, Or Phony Offsets. When discerning the deficit impact of a bill, investors will boil changes down to their all-in impact on Treasury issuance this year and in the future. An offset that "scores well" but does not actually change Treasury issuance will not fool investors. Investors do not fixate on 10-year totals – so early sunsets are taken with a grain of salt. Likewise, if an offset cancels spending that hasn't taken place yet, it will not reduce Treasury issuance from current levels (despite a score that implies deficit reduction). That doesn't mean those policies are without merit though. If future spending yet to take effect is wasteful, it is still good to cancel it.

Lastly, adjusting baselines to achieve a different score will not change investor perceptions about whatever the policy change may be. When it comes to the TCJA, investors would be concerned if a current policy baseline is used to argue a policy change has no cost and therefore no fiscal restraint whatsoever is needed. However, this is not an indictment of a current policy baseline, per se, at least not conceptually. Private sector economists implicitly use a current policy baseline when estimating the economic impact of policy changes. If an existing policy is extended, on incremental basis, there is no net expansion in the growth impulse. In other words, what makes investors concerned about the use of a current policy baseline, in the current fiscal context, if it is used as a crutch to avoid hard decisions as well as the prospects for it to be used by future Congresses to enact costly policies without offsets.

Demonstrate Credibility On Fiscal Restraint. Policymakers often talk about the importance of fiscal restraint, but this is easier said than done. I understand that in legislating, perfection should not be the enemy of the good, that major adjustments take time, and this upcoming reconciliation bill is not a vehicle to solve all of our fiscal problems. But there is no better time than the present to cut spending and pursue deficit reduction. Appropriations bills require bipartisan compromise – reconciliation bills, which address mandatory spending, do not. The spending cuts being contemplated in the House, at $1.5 trillion over a decade, average about 0.4% of GDP. If Republicans cannot accomplish cuts on this scale now, what does it say about the ability of Congress to ever control spending? Will there be another reconciliation bill in 2026? Given the national security risks the US faces and the need for greater defense spending, is it feasible there will be bipartisan deals to restrain non-defense spending while accommodating greater defense spending? Will there be budget cuts right before midterms? What happens to the prospects for spending cuts if majorities change and we face divided government in 2027? Will there be spending cuts in 2028 just before another presidential election? It is easy to keep kicking the can down the road, but now is the time to demonstrate credibility. Having said all of that, no single party will solve our budget problems alone. In order for solutions to be durable, and given the enormity of our fiscal challenges, it is important to ultimately pursue bipartisan reforms to entitlement programs.

Focus On Growth, But Balance Fiscal Objectives. Good tax policy is necessary to foster economic growth and robust economic growth is necessary if we are going to solve our fiscal challenges. However, good tax policy does not just mean lower taxes by any means necessary. Resources are scarce and policymakers should maintain a tax reform mindset when deciding which policies to prioritize. This means pursuing growth, neutrality, and simplicity while balancing fiscal objectives. Tax changes that lower marginal rates on work and investment will help spur economic growth and productivity which will raise wages and have knock on positive effects for the Treasury. There are many ways to extend the TCJA (or even better, improve upon it), lock in the most pro-growth, neutrality enhancing, and simplifying aspects of the law while also mitigating its impact on the budget. In a recent paper I co-authored with AEI scholar Kyle Pomerleau, we proposed two ways to do that on a revenue-neutral basis.[8] In the paper we propose "incremental" reforms that maintain the structure of TCJA but trim its cost while the "aggressive" proposal makes major tax reforms such as converting the corporate income tax to a destination-based cash flow tax (DBCFT).

[1] This analysis excludes 2022 through 2024 in order to focus on the historical relationship between the unemployment rate and deficits.
[2] The analysis uses recent CBO and AEI estimates on the cost of extending the individual and corporate provisions of the TCJA but does not incorporate any change in GDP that would likely result from the policy change.
[3] https://www.cbo.gov/publication/60314
[4] https://www.cbo.gov/system/files/2025-03/61198-Economic-Conditions.pdf
[5] https://www.cbo.gov/publication/60169
[6] https://www.fitchratings.com/research/sovereigns/fitch-downgrades-united-states-long-term-ratings-to-aa-from-aaa-outlook-stable-01-08-2023
[7] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5229097
[8] https://www.aei.org/wp-content/uploads/2024/04/Making-the-Tax-Cuts-and-Jobs-Act-Permanent.pdf?x85095