THE FISCAL STATE OF THE NATION

Testimony for the House Budget Committee

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May 7, 2025

Chairman Arrington, Ranking Member Boyle, and members of the committee, thank you for the opportunity to testify today on the serious fiscal challenges facing our nation. The United States is on an unsustainable trajectory. Our national debt held by the public will soon exceed $30 trillion, with annual deficits approaching $2 trillion. Interest payments on our debt now surpass the entire defense budget, and entitlement obligations over the next 75 years total an astounding $78 trillion.

These figures, which I presume are well-known to members of your committee, are more than just numbers on a balance sheet—they represent a growing economic burden that threatens long-term prosperity. Recent inflation has shown how unchecked spending and borrowing fuel economic instability, drive up interest rates, and erode the spending power of wages and savings.

But the risks extend beyond the economy—our rising debt jeopardizes the nation's capacity to invest in defense and respond to future threats and emergencies.

Today, I will make four key points:

1. Rising interest payments on the national debt will increasingly crowd out funding for essential government activities and increase the risk of future debt crises.
2. Delaying fiscal reforms will weaken long-term economic growth and prosperity.
3. Higher tax rates would harm economic activity and be counterproductive in addressing the debt crisis.
4. Spending reforms are the key to avoiding fiscal calamity.

The Interest Coverage of US Federal Government Revenues

The fiscal situation of the United States is highly unstable. Absent a credible commitment to pro-growth tax policy and major changes in long-term spending that would reduce structural deficits, America is headed for a fiscal crisis.

A leading indicator of our fiscal crisis is the federal government's increasing interest payments on its debt. If you speak to bond investors, they'll tell you that probably the most crucial statistic for them to know is interest coverage: to what extent can the issuer cover its interest payments with its cash flows? I have looked at this closely for the United States, by studying interest payments as a percent of revenue collections.

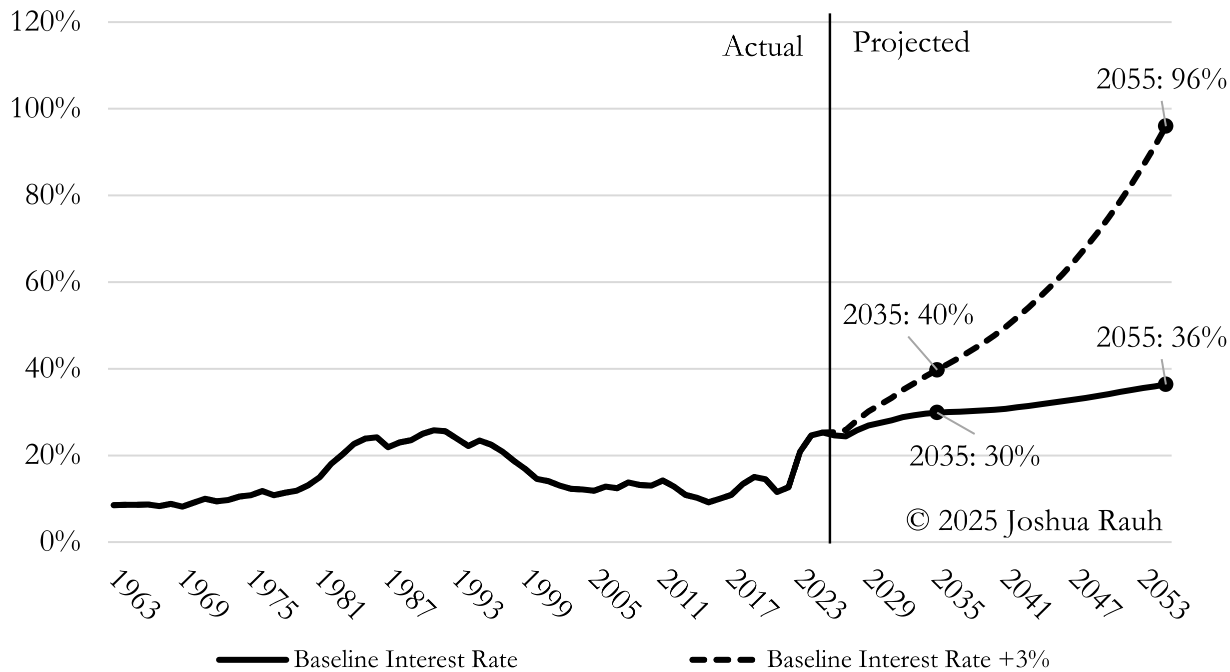
Using the Congressional Budget Office's (CBO) figures and current projections, I calculate that net interest costs were 17.9 percent of all revenues in 2024, and are scheduled to rise to 22.2 percent of all federal revenues in 2035, putting extraordinary pressure on discretionary spending and entitlement programs.[1]

But it could turn out to be much worse. The Congressional Budget Office (CBO) projects the U.S. economy will average 1.8 percent real GDP growth and 2 percent inflation over the next decade. Economic forecasting, however, is highly uncertain—central banks failed to anticipate the inflation surge of 2022, which led to unexpectedly high interest rates, just as markets in the 1960s did not foresee rates reaching 15 percent by 1980. Higher interest rates on federal debt could also result from rising risk premiums if bondholders grow concerned about the government's fiscal trajectory. And indeed, the current 10-year forward rate for 10-year Treasurys exceeds CBO's 2035 projection of 3.8 percent by more than one percentage point, indicating that markets already anticipate substantially higher rates than CBO projects.

The nation's historically high debt levels mean that the projections do not have to be off by much to produce a rapid deterioration in the fiscal outlook. The average interest rate on the federal debt was 3.4 percent in 2024. If real interest rates on the federal debt rise gradually over the next decade—ending just 1 percentage point higher than projected in the CBO's March 2025 forecasts—I calculate that the fiscal impact would be significant. By 2035, interest payments would consume 29.5 percent of revenues and 39.7 percent of revenues excluding Social Security OASDI payroll tax revenues.[2] A 1 percentage point increase in rates relative to the CBO's forecast would push the average nominal interest rates on federal debt to just 4.6 percent—not the 7.2 percent level seen in 1991 or the 9.2 percent level seen in 1982.

If the average real interest rate on the federal debt were to continue rising at the pace of just 1 percentage point per decade above projections during the period 2035 to 2055, 96 cents every dollar of revenue the federal government collects—excluding Social Security OASDI payroll taxes—will go toward servicing past borrowing rather than funding current operations, national security, or social programs.[3]

Interest as Share of Federal Revenues Exc. SS OASDI through 2055 with 3% Higher Average Interest Rate Phased in 2026-2055



Source: CBO March 2025, *The Long-Term Budget Outlook: 2025 to 2055*, author's calculations from Supplemental Table 1. Historical Social Security OASDI payroll tax revenue from Table 4-3 of the Social Security Administration's Trust Fund Data, and projections from the CBO's August 2024 *Long Term Projections for Social Security*. Scenario of higher interest rate (+3%) is author's calculations.

A Failure to Act Now Will Harm Economic Growth and Prosperity in The Long Term

High government borrowing competes with private investment, driving up interest rates and making it more expensive for businesses to expand, homeowners to secure mortgages, and entrepreneurs to access capital. Additionally, as federal interest costs grow, they consume an increasing share of government resources, crowding out essential spending on infrastructure, education, and national security.

Financial markets are already taking note. There are several reasons the cost to the US government of borrowing over 30 years was 2.3 percent per year in December 2019 but is 4.75 percent today. One clearly relates to the market's understanding that interest rates will be higher in the future, a fact closely related to perceptions of our debt, deficits, and inflation.

My colleague at Stanford University Graduate School of Business, Hanno Lustig, presented work at the 2024 Jackson Hole Economic Symposium showing that as government debt rose in 2020 and 2021, private investors demanded higher yields to compensate for increased risk.[4] This is a critical warning sign, and we saw it even in an environment where central banks were doing everything they could to keep yields down and dampen such signals, a scheme that history tells us cannot go on forever without inflationary consequences.

The risks of the effects of higher future debt on interest rates are skewed to the upside. The CBO estimates that a one percentage point increase in the debt-to-GDP ratio raises interest rates by 2 basis points.[5] Other estimates, however, are significantly higher.[6] Moreover, these estimates, mostly based on recent history, cannot account for how bondholders will react to unprecedented levels of future borrowing.

The consequences of failing to address these issues will be severe. The most serious consequence of inaction is the long-term erosion of economic opportunity through higher interest rates, higher inflation, and less availability of capital.

At a recent conference about fiscal policy challenges we hosted at Stanford University, the prevailing sentiment among the budget experts in attendance was that a U.S. fiscal crisis is a question of "when," not "if." Treasurys may be considered a safe asset for now, but once lenders see that the fiscal trajectory isn't changing, they'll raise the price it costs us to borrow. Markets won't wait until we literally cannot meet interest payments without slashing government spending—they adjust in real time to expectations of future debt and deficits. A debt spiral could follow.

This year has shown how policy changes can shake Treasury markets and the broader economy. A debt spiral would be far more disruptive—and policymakers would have few tools to respond.

Higher Tax Rates Are Not the Answer

Some suggest that raising tax rates is the answer. The scale of our fiscal challenge, however, makes this approach economically dangerous.

Raising marginal tax rates discourages work, savings, and investment. Fewer people working means lower growth. Fewer dollars saved or invested means fewer new businesses and jobs are created. Fewer opportunities means everyday Americans are left behind. We saw how rapid economic growth in the first Trump administration before the pandemic occurred led to more wage growth for the bottom of the income distribution than wage growth for those at the top.[7]

My own research at Stanford University has extensively studied how tax policy affects migration and economic activity. When governments impose high tax burdens, particularly on high earners and businesses, capital moves elsewhere—leading to lower-than-expected revenues and reduced economic growth.

One source of evidence is the state of California. When the state raised tax rates in 2013, my coauthor Ryan Shyu and I found that taxpayers adjusted their behavior in response to the tax hike, significantly reducing their taxable income. Excluding those who left California, for every 1 percent drop in share of income they could keep, high-income earners cut their reported income by 3.0 percent, ostensibly either working less, starting fewer businesses, expanding existing business less, or engaging in more distortionary tax avoidance. Overall taxpayer responses eroded 60 percent of the potential revenue gains within the first two years, over 90 percent of which was driven by the reduction in economic activity of the high earners who stayed in the state.[8]

CBO's own research makes clear that the impact of deficits depends on how they are created.[9] Raising taxes to close the fiscal gap does not have the same effect as cutting spending. Tax hikes reduce incentives for investment and economic expansion, while spending cuts—particularly reductions in wasteful or inefficient programs—can improve fiscal stability without harming growth. The CBO has found that increasing the debt-to-GDP ratio by one percentage point to finance new spending raises interest rates three times more than borrowing to finance tax cuts.

What does this all say about the immediate tax policy challenge we face, namely the expiration of the 2017 Tax Cuts and Jobs Act (TCJA) and other proposed tax cuts? Extending the law's tax cuts without maintaining base-broadening provisions like the SALT cap would significantly increase deficits. But letting the law expire or offsetting its effects through other tax hikes would stifle investment and consumption. To address this, I urge Congress to make permanent the pro-growth provisions, such as the rate reductions and full expensing of capital, while extending or implementing only temporarily (for example for two years) tax cuts that will add to deficits while doing little to grow the economy.

This is a critical moment for policymakers to enact structural fiscal reforms while avoiding growth-destroying tax hikes.

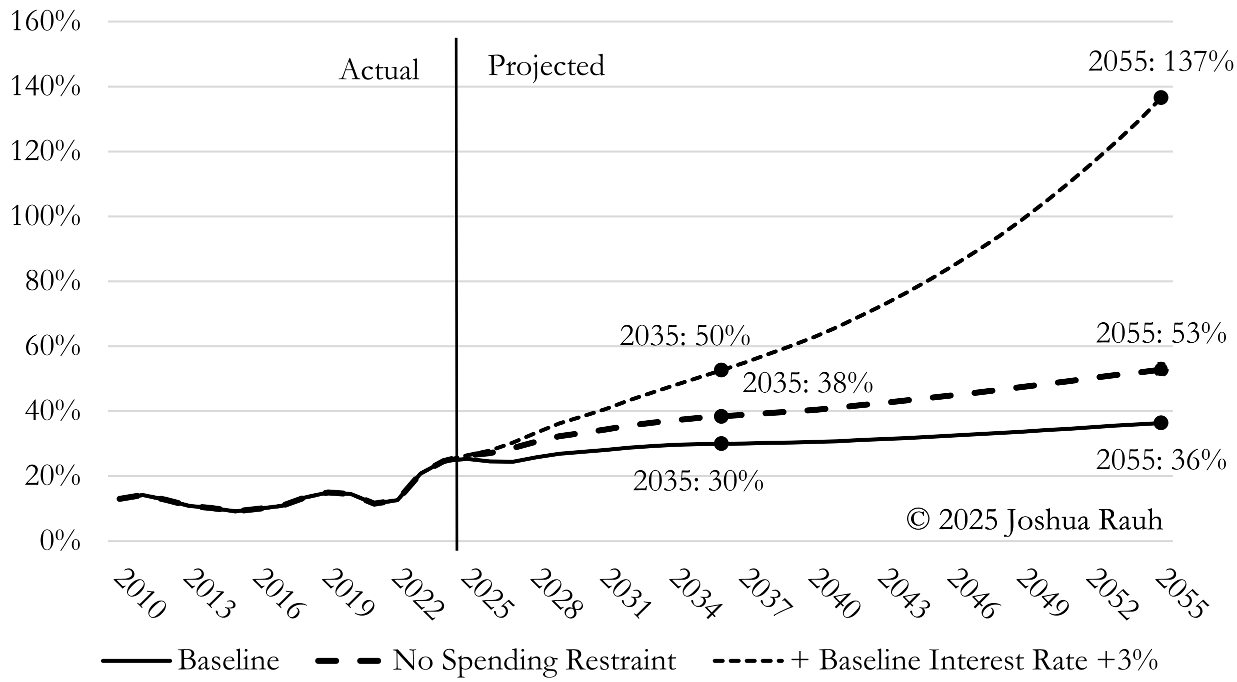
Spending Restraint Is the Key

The CBO's 2025 Long-Term Budget Outlook makes clear where fiscal policymakers must focus their attention: federal spending.[10] The report projects federal revenues to grow steadily from 17.1 to 19.3 percent of GDP over the next 30 years. In comparison, from 1995 to 2024, federal revenue averaged 17.2 percent of GDP. In short, the problem isn't a lack of revenue. The problem is that federal spending, already above 23 percent of GDP, is projected to grow even faster, primarily by interest spending and entitlement programs. In 2055, spending is projected to reach 26.6 percent.

The largest driver of this increase is the unchecked growth of mandatory spending programs, particularly Social Security and Medicare. Social Security spending, which currently accounts for 5.2 percent of GDP, will increase to 6.1 percent by 2055. Medicare, which currently represents 3.1 percent of GDP, is projected to reach 5.2 percent of GDP over the same period. Medicaid and other healthcare programs will also expand, further accelerating federal outlays. Over three quarters of future spending growth is due to these major entitlements and interest payments.[11]

Absent structural reforms, these spending trends will lead to an unsustainable fiscal trajectory, requiring either deep cuts in other federal priorities or significant tax increases that could undermine economic growth. This is especially important as Congress considers a pro-growth tax plan. Failing to include meaningful spending restraint in this year's reconciliation bill would further deteriorate the fiscal outlook. I estimate that, without spending restraint, interest payments as a share of federal revenues—excluding Social Security OASDI payroll taxes—would rise to 53 percent by 2055, up from 36 percent, under the CBO's baseline.[12] And that assumes interest rates remain near historic lows. If real interest rates rise by three percentage points, and Congress enacts a reconciliation bill without spending restraint, the figure would climb to 137 percent.

Interest as Share of Federal Revenues Exc. SS OASDI through 2055 with No Spending Restraint in the Reconciliation Bill



Source: CBO March 2025, *The Long-Term Budget Outlook: 2025 to 2055*, author's calculations from Supplemental Table 1. Historical Social Security OASDI payroll tax revenue from Table 4-3 of the Social Security Administration's Trust Fund Data, and projections from the CBO's August 2024 *Long Term Projections for Social Security*. Scenario of higher interest rate (+3%) is author's calculations.

Policymakers cannot rely on economic growth alone to resolve this challenge. The federal debt and its ensuing interest payments are so high that even a return to robust economic growth will not solve our fiscal imbalance. Moreover, much of the federal spending is now linked to economic growth. Both Social Security and Medicare spending are tied to economy-wide productivity growth, meaning that economic improvements will also drive higher spending on these programs. CBO estimates that if productivity rates are 0.5 percentage points higher than anticipated over the next 10-years, mandatory spending would rise by $200 billion.[13] These effects would be even larger beyond the 10-year budget window.

Spending reforms must thus be a key component of any credible plan to restore fiscal stability. Fortunately there are many good options because there is a lot of government waste and general government spending that isn't broadly helping the American people, but rather benefiting small groups of special interests. The following examples illustrate just a few of the reforms that are Byrd-Rule eligible and could collectively save nearly $1 trillion over the next decade:

- **Eliminate Medicaid provider taxes**: Closing a loophole that allows states to manipulate federal Medicaid funding would reduce deficits by $610 billion over 10 years.[14]
- **Implement Medicare site neutral payments**: Standardizing payments for identical services across hospitals and doctor's offices would save $160 billion over 10 years.[15]
- **Improve cost-sharing rules in Medicare**: Adjusting cost-sharing rules in supplemental Medicare plans to reduce unnecessary healthcare use would save $130 billion from 2028 to 2034.[16]
- **Right-size federal employee benefits**: Raising retirement contributions and shifting health benefits to an inflation-adjusted voucher system for federal civilian workers would save $70 billion over the next decade.[17]

Of course, achieving a sustainable federal budget will require far more spending reforms. This means reevaluating existing entitlements programs to ensure spending is targeted to those most need and implementing cost-saving measures in healthcare. Simply delaying action will only make the necessary adjustments more severe and disruptive in the future. A proactive approach to spending restraint can help preserve critical government services while ensuring that federal spending remains sustainable for future generations.

Conclusion

The good news is that financial markets are not irrational; they respond to clear and credible fiscal policies. If Congress enacts meaningful reforms—addressing entitlement growth, eliminating wasteful spending, and fostering a stable, pro-growth tax environment—markets WILL reward those decisions.

The fiscal challenges before us are severe, but they are still not insurmountable. However, the time for decisive action is now. Responsible fiscal policy is not just an economic necessity—it is essential to preserving American economic strength and opportunity for both current and future generations.

Thank you for your time, and I look forward to your questions.

[1] Calculations are based on data from Congressional Budget Office. *The Long-Term Budget Outlook: 2025 to 2055*. March 27, 2025. https://www.cbo.gov/publication/61187.

[2] For a full discussion of these calculations see Rauh, Joshua D. "Playing with Fire: The Interest Coverage of US Federal Government Revenues." *Liberty Lens.* October 7, 2024. https://libertylensecon.substack.com/p/playing-with-fire-the-interest-coverage.

[3] This assumes real interest rates gradually rise by three percentage points over the next three decades relative to CBO's baseline projections in their March 2025 budget projections. Under this scenario, interest payments would consume 74.1 percent of total federal revenue and 95.9 percent excluding OASDI and HI payroll taxes.

[4] Gómez-Cram, Roberto, Howard Kung, and Hanno Lustig. "Government Debt in Mature Economies. Safe or Risky?" Federal Reserve Bank of Kansas City, Jackson Hole Economic Policy Symposium, August 22–24, 2025. https://www.kansascityfed.org/documents/10341/Hanno_Lustig_Paper_JH.pdf

[5] Neveu, Andre R. and Jeffrey Schafer. "Revisiting the Relationship Between Debt and Long-Term Interest Rates." *Congressional Budget Office Working paper 2024-05*. December 2024. https://www.cbo.gov/system/files/2024-12/60314-DSIR-WP.pdf.

[6] For a review of the literature on sensitivity of interest rates to increase federal borrowing, see Salmon, Jack. "Long-Term Interest Rate Projections and the Federal Debt." *Liberty Lens.* October 22, 2024. https://libertylensecon.substack.com/p/long-term-interest-rate-projections.

[7] Goodspeed, Tyler. "Testimony of Tyler Goodspeed before the U.S. Senate Committee on the Budget." September 20, 2023. https://www.budget.senate.gov/imo/media/doc/goodspeed_testimony_920.pdf.

[8] Rauh, Joshua and Ryan Shyu. "Behavioral Responses to State Income Taxation of High Earners: Evidence from California." *American Economic Journal: Economic Policy* 16(1). February 2024. 34–86. https://www.aeaweb.org/articles?id=10.1257/pol.20200500.

[9] Gamber, Edward and John Seliski. "The Effect of Government Debt on Interest Rates." *Congressional Budget Office Working Paper 2019-01*. March 2019. https://www.cbo.gov/system/files/2019-03/55018-Debt%20Rates%20WP.pdf.

[10] Congressional Budget Office. *The Long-Term Budget Outlook: 2025 to 2055*. March 27, 2025. https://www.cbo.gov/publication/61187.

[11] From 2025 to 2055, major entitlements and interest payments account for 79 percent of the growth in total federal outlays. Major entitlements include Social Security, Medicare, Medicaid, CHIP, and ACA premium subsidies. Author's calculations from Congressional Budget Office. "Long-Term Budget Projections." January 2025. https://www.cbo.gov/data/budget-economic-data#1.

[12] This calculation assumes that there are no spending reductions in the reconciliation bill.

[13] Author's calculation using Congressional Budget Office. *Workbook for How Changes in Economic Conditions Might Affect the Federal Budget: 2024 to 2034*. https://www.cbo.gov/publication/60074.

[14] Option 5 in Congressional Budget Office. *Options for Reducing the Deficit: 2025 to 2034*. December 2024. https://www.cbo.gov/system/files/2024-12/60557-budget-options.pdf.

[15] Option 16 in Congressional Budget Office. *Options for Reducing the Deficit: 2025 to 2034*. December 2024. https://www.cbo.gov/system/files/2024-12/60557-budget-options.pdf.

[16] Option 12 in Congressional Budget Office. *Options for Reducing the Deficit: 2025 to 2034*. December 2024. https://www.cbo.gov/system/files/2024-12/60557-budget-options.pdf.

[17] Raising all federal employees required retirement contributions to 4.4 percent would reduce deficits by $40 billion in the 10-year budget window. Providing a premium voucher to federal workers and indexing its growth to the CPI-U would reduce deficits by $32 billion. Options 9 and 76 in Congressional Budget Office. *Options for Reducing the Deficit: 2025 to 2034*. December 2024. https://www.cbo.gov/system/files/2024-12/60557-budget-options.pdf.).