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HARVARD UNIVERSITY

The U.S. Fiscal Outlook

Serious, Doable, and Waiting for a Deadline

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Grappling with U.S. Deficits and Debt · Peterson Institute for International Economics · Washington DC

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OUTLINE

1. The U.S. Fiscal Situation
2. How Worried Should We Be?
3. What Can Be Done?

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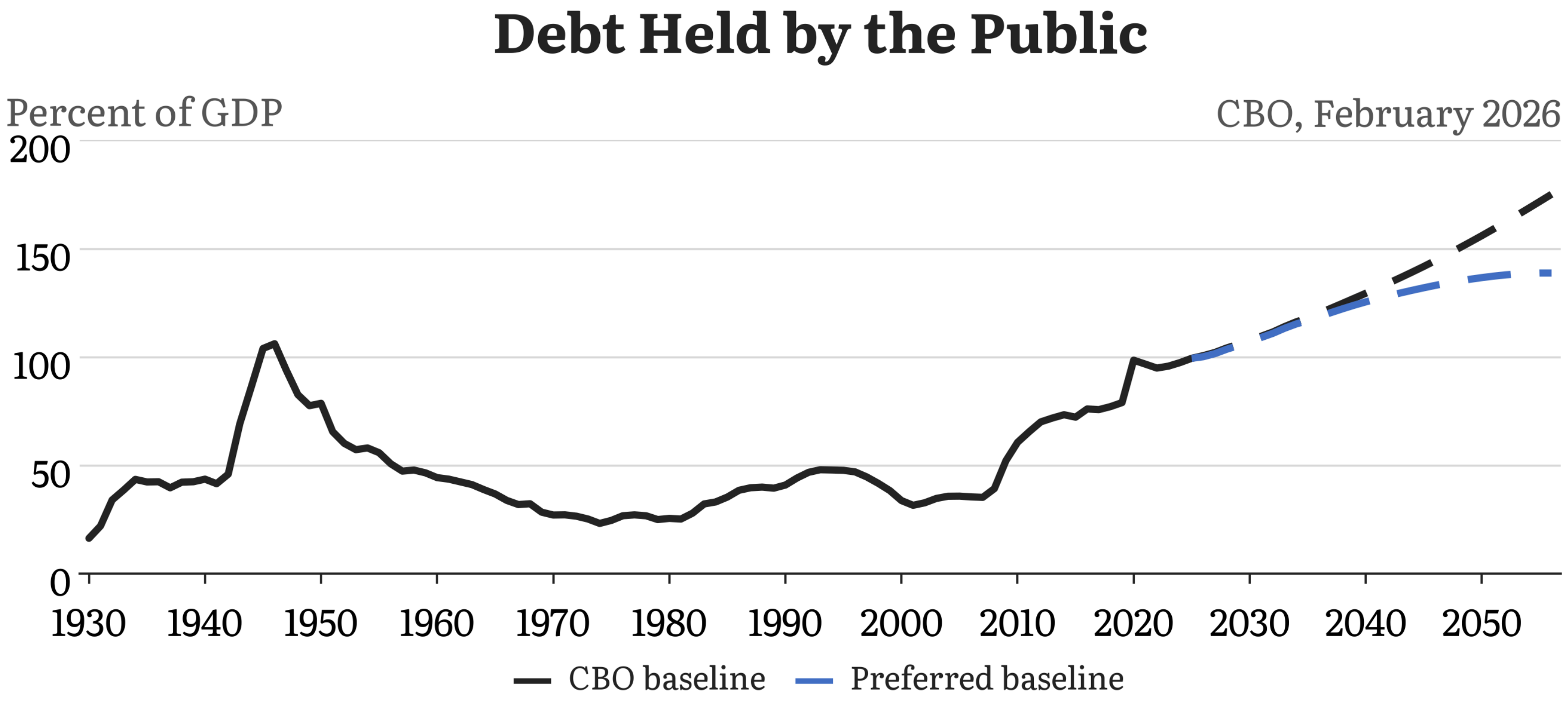
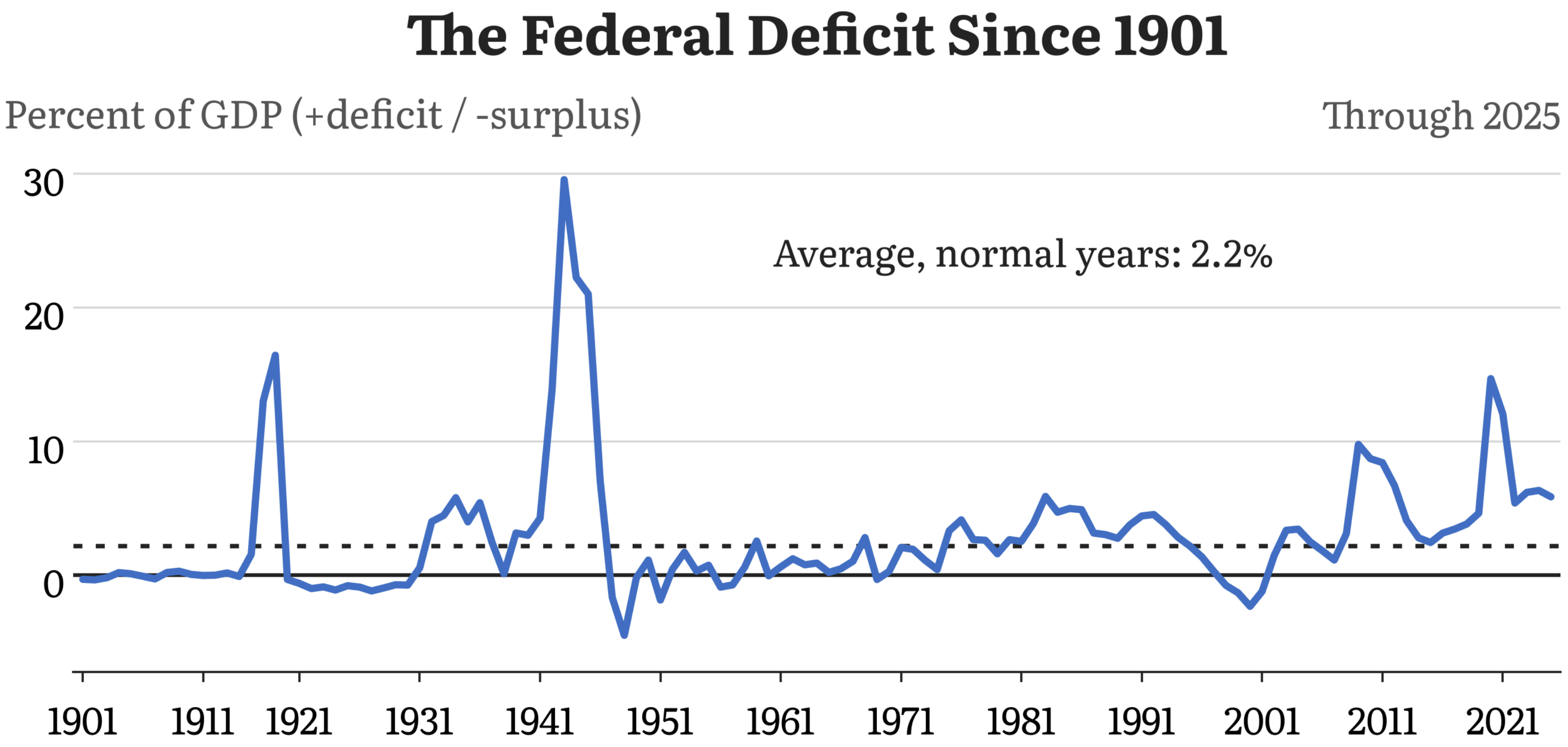
Debt increased a lot—and is projected to continue increasing



Note: Preferred baseline adds to CBO: half of four policy changes (tax cuts extended, low-income cuts reversed and ACA credits extended, tariffs expire, defense at a constant share of GDP); Treasury rates held at current market levels; productivity growth 0.5pp a year faster; rates rise 2bp per pp debt/GDP exceeds CBO's.
Source: Congressional Budget Office; OMB; BEA; Federal Reserve; author's calculations.

Deficit is higher than any time except World Wars, the financial crisis and COVID



Note: Fiscal years. The average for "normal years" excludes NBER-dated recessions, U.S. participation in World War I and World War II, and the COVID-19 pandemic.
Source: OMB; CBO; BEA; Census Bureau, Historical Statistics of the United States; NBER; author's calculations.

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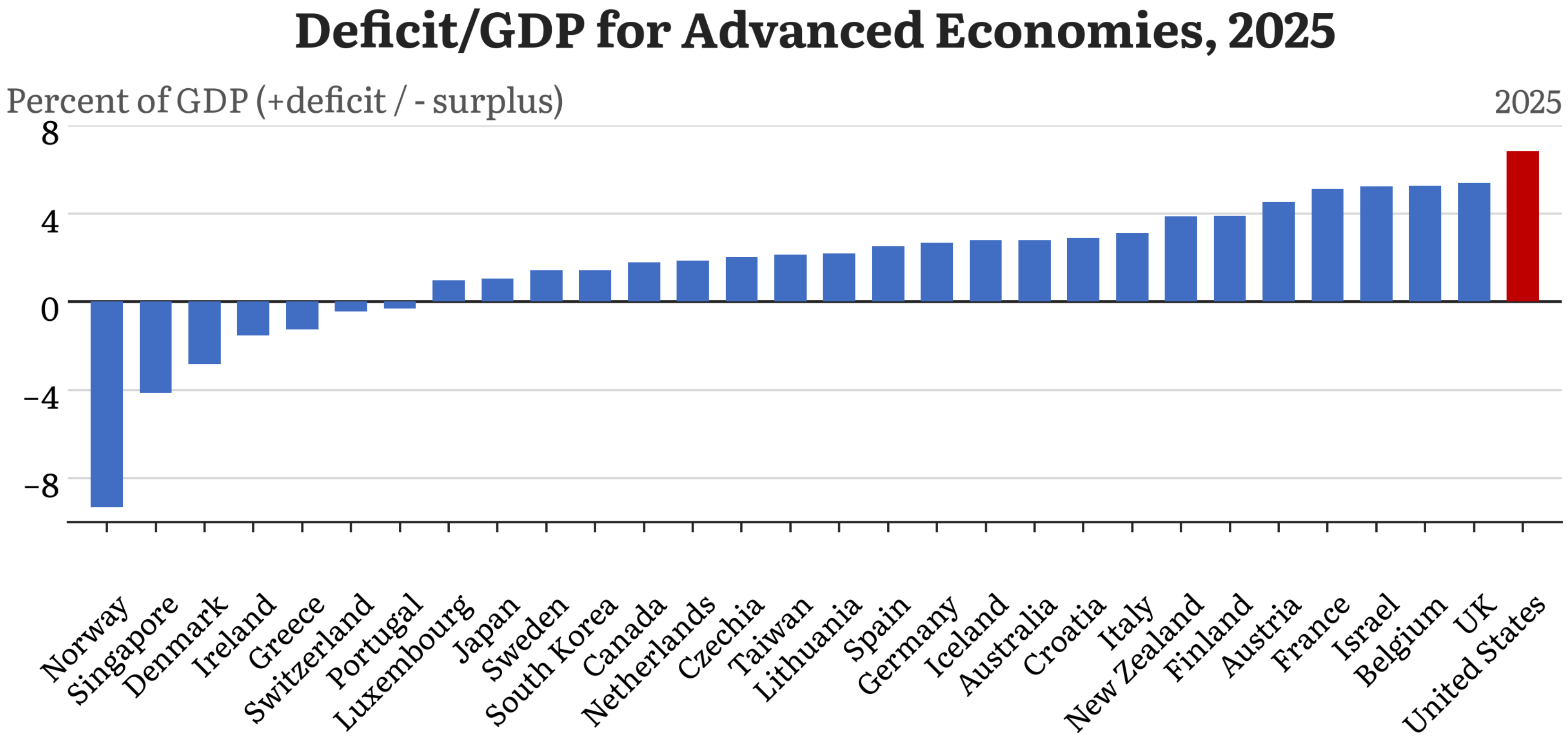
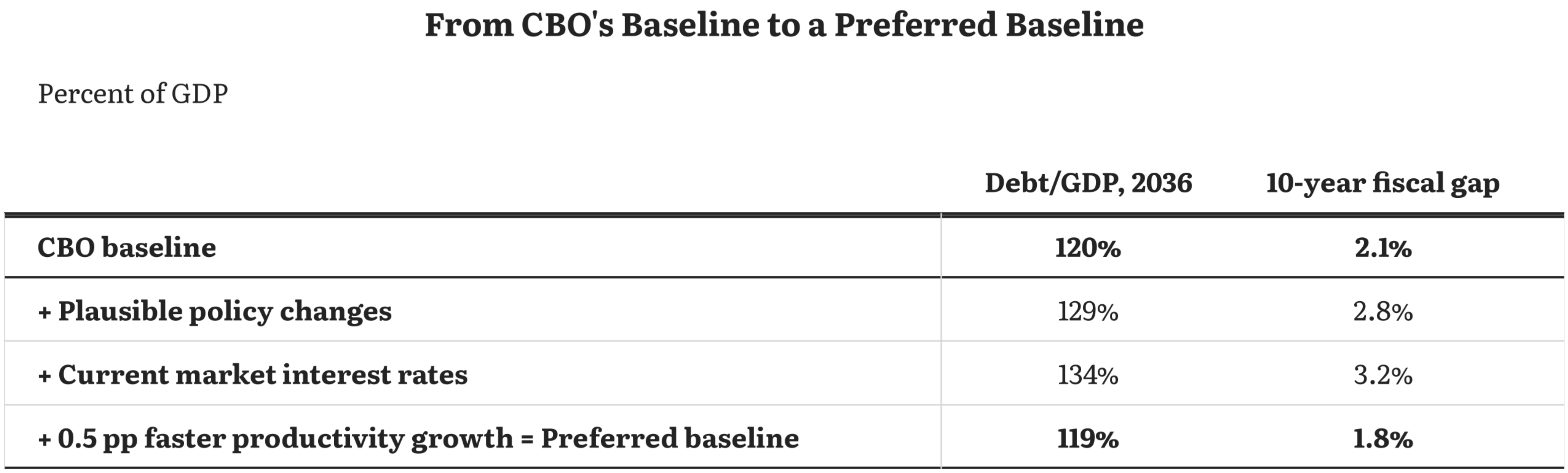
Deficit is higher than any other rich economy



Source: International Monetary Fund Fiscal Monitor; author's calculations.

Nevertheless, the adjustment needed for fiscal stability is doable, probably ~2 percent of GDP



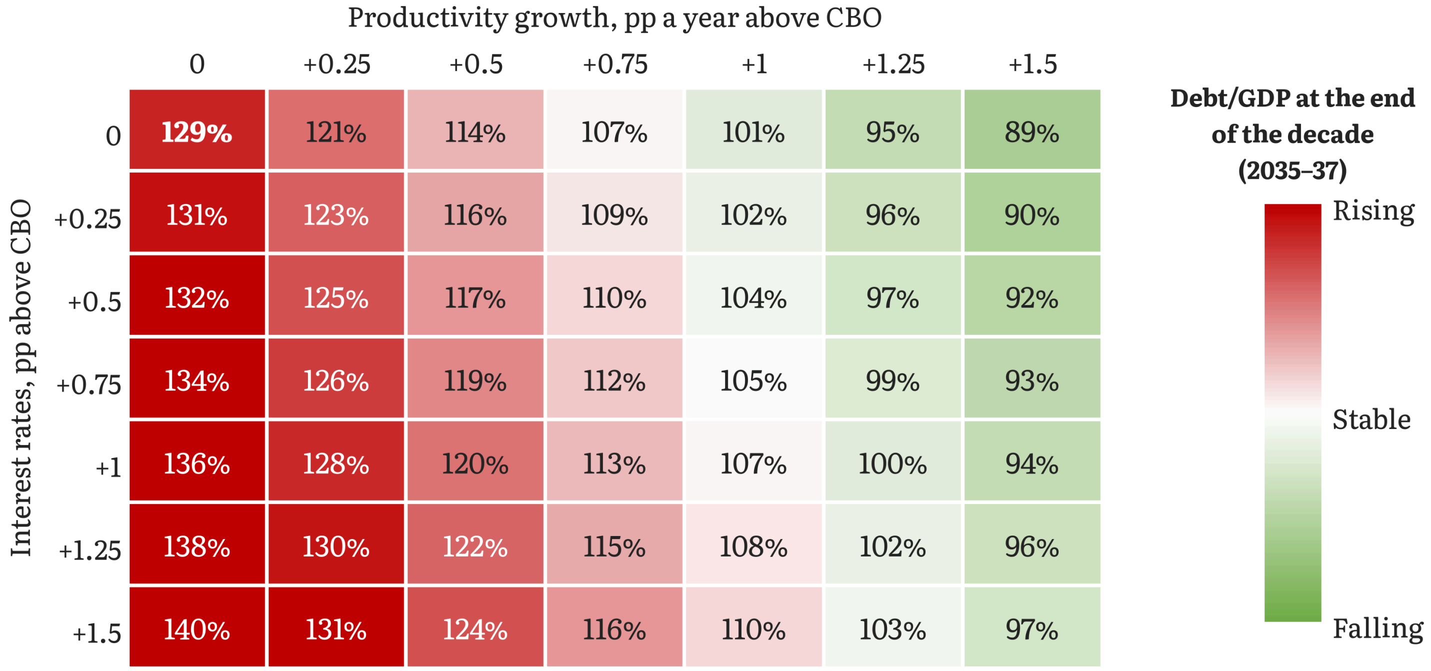
From CBO's Baseline to a Preferred Baseline

Percent of GDP

	Debt/GDP, 2036	10-year fiscal gap
CBO baseline	**120%**	**2.1%**
+ Plausible policy changes	129%	2.8%
+ Current market interest rates	134%	3.2%
+ 0.5 pp faster productivity growth = Preferred baseline	**119%**	**1.8%**

Note: Fiscal gap: permanent cut in the primary deficit from 2027 that returns debt to its 2025 level (99% of GDP) in 2036.
Source: Congressional Budget Office; OMB; BEA; Federal Reserve; author's calculations.

A productivity boost of about 1.25pp is needed to stabilize the debt: possible but not probable



Debt Held by the Public in 2036

Percent of GDP

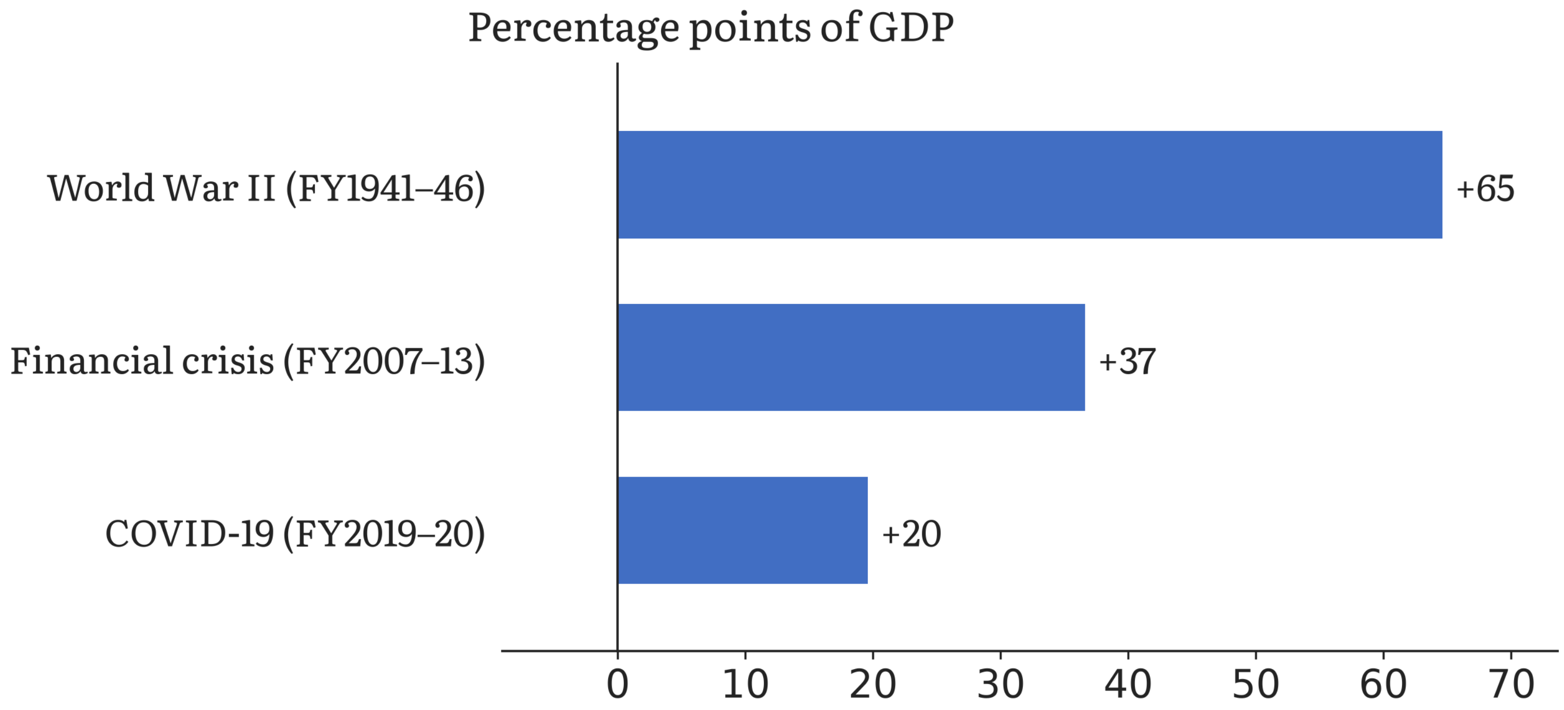
Productivity growth, pp a year above CBO

Interest rates, pp above CBO	0	+0.25	+0.5	+0.75	+1	+1.25	+1.5
0	**129%**	121%	114%	107%	101%	95%	89%
+0.25	131%	123%	116%	109%	102%	96%	90%
+0.5	132%	125%	117%	110%	104%	97%	92%
+0.75	134%	126%	119%	112%	105%	99%	93%
+1	136%	128%	120%	113%	107%	100%	94%
+1.25	138%	130%	122%	115%	108%	102%	96%
+1.5	140%	131%	124%	116%	110%	103%	97%

Note: Starts from CBO plus half of four policy changes (tax cuts extended, low-income cuts reversed and ACA credits extended, tariffs expire, defense at a constant share of GDP). Interest rates are higher by the amount shown every year from 2027. Productivity: growth higher by the amount shown every year. Rates also rise 2bp per pp debt/GDP exceeds CBO's.
Source: Congressional Budget Office; Federal Reserve; author's calculations.

But we need to be mindful that most debt increases are large rare events not these forecast issues

Change in Federal Debt as a Share of GDP Around Major Events



Note: Debt held by the public, from the last fiscal year before each event to the year the ratio stopped rising.
Source: Office of Management and Budget; Congressional Budget Office; author's calculations.

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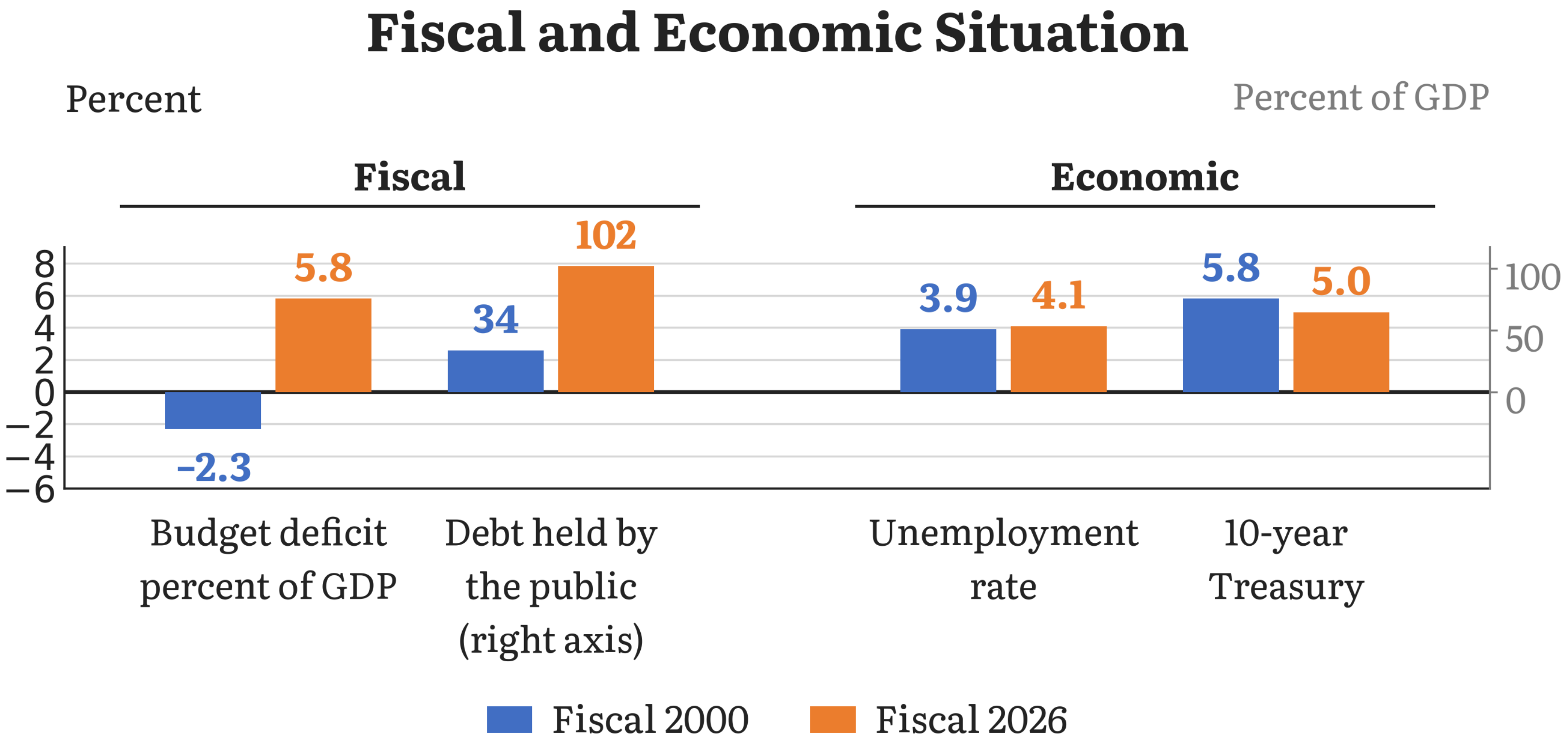
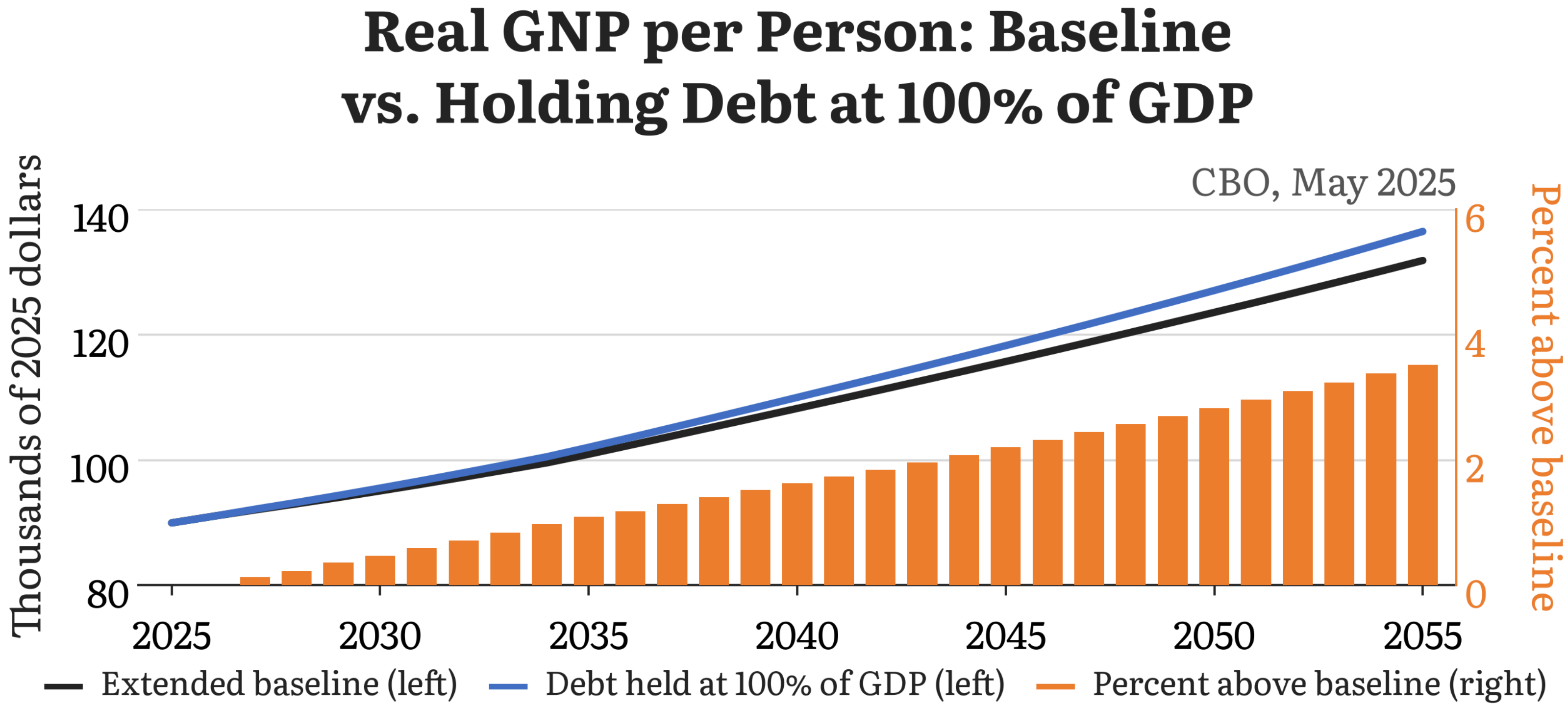
So far it’s been much less catastrophic than I would have expected



Note: A negative deficit is a surplus. The fiscal 2026 deficit is CBO's February 2026 baseline, with eleven months of Treasury actuals tracking about 5.5. Debt held by the public is the September 18, 2026 figure; unemployment is September 2000 and August 2026; the 10-year is the last trading day of each fiscal year, September 29, 2000 and September 21, 2026.
Source: Congressional Budget Office; Treasury; Bureau of Labor Statistics; author's calculations.

The standard estimates are like termites in the woodwork



Note: Calendar years. Scenario holds debt held by the public at its 2025 share of GDP (about 100%) through 2055 with an unspecified mix of lower noninterest spending and higher revenues.
Source: Congressional Budget Office, Long-Term Budget Outlook Under Alternative Scenarios (May 2025); author's calculations.

But what about the unknown unknowns

- We can model economic effects of deficits and they are linear and growing slowly each year.
- The bigger concern is nonlinear dynamics. These are not simply or even primarily a function of economic variables--institutions and perception matters a lot too.
- Little history to judge the magnitude of the risk. But we probably don't want to find out the hard way.

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2 percent of GDP deficit adjustment is doable just not something we have done recently

Deficit-reduction law	Percent of GDP
Omnibus Budget Reconciliation Act of 1990	**−1.8%**
Omnibus Budget Reconciliation Act of 1993	**−1.5%**
Balanced Budget Act and Taxpayer Relief Act of 1997	**−0.9%**
Affordable Care Act of 2010	**−0.1%**
Budget Control Act of 2011	**−0.5%**
Inflation Reduction Act of 2022	**−0.1%**
Fiscal Responsibility Act of 2023	**−0.4%**
Tariffs imposed by executive action in 2025	**−0.5%**

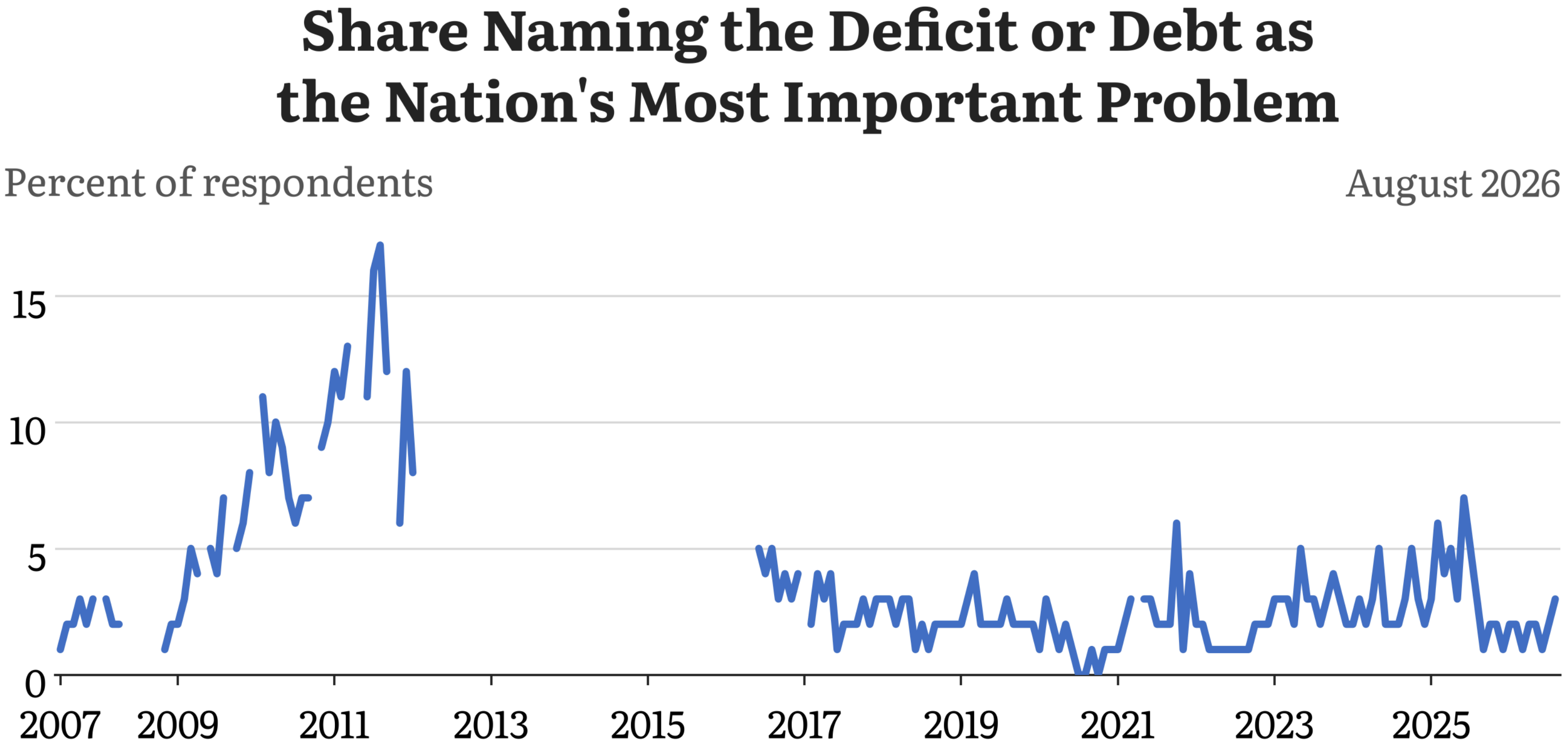
Note: Effect on the primary deficit in the final year of the estimating window: five years for laws through 1997, ten years after that. Tariffs are those imposed in 2025, before the February 2026 Supreme Court ruling.

Source: Congressional Budget Office; Joint Committee on Taxation; Office of Management and Budget; author's calculations.

What might force action?

- **A fiscal crisis.** Will one happen and when? Can we wait?
- **Public opinion.** What shapes public opinion, interest rates?
- **Social Security and Medicare solvency.** Social Security's retirement trust fund is projected to be exhausted in 2032 and Medicare Hospital Insurance in 2033--solving them totals about 1.75 percent of GDP.

But no one seems to care much right now



Note: February 2012 to May 2016 not recoverable from public sources; readings Gallup reports as below 0.5% are shown as zero.
Source: Gallup, Most Important Problem (monthly).

Summary and Conclusions

- The U.S. deficit and debt are very high and rising by historical perspective and compared to other countries.
- Higher productivity could get us out of the problem but that is probably not the median case.
- Debt is undoubtedly already costing our economy--but also is not demonstrably huge,
- The most attractive action forcing event going forward is Social Security and Medicare solvency.
- Deficit reduction not the only issue that matters--need a more people and future-oriented budget, beyond the scope of my discussion today.