COMMITTEE FOR A
RESPONSIBLE FEDERAL BUDGET

Interest Rates and the Debt

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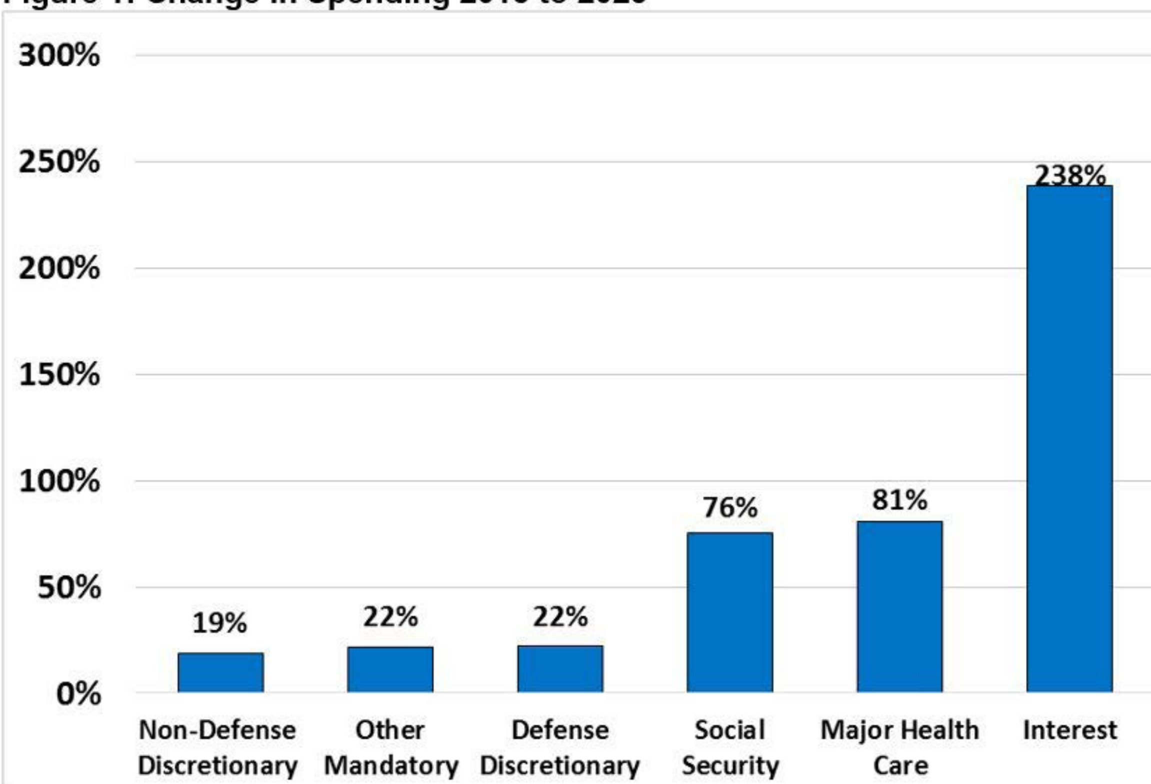
Last year, the federal government spent about $223 billion on net interest payments to service our debt, the equivalent of roughly 6 percent of the budget and 1.2 percent of Gross Domestic Product (GDP). As a share of the economy, the government has not spent this little on interest since the 1960s, but this trend is soon set to reverse.

Currently, interest rates are at unprecedented and historic lows – the 10-year note currently pays about 2.3 percent in interest and the 3-month Treasury bill is about 0.25 percent. As the national and global economy recovers and the Federal Reserve unwinds its expansionary monetary policy, interest rates are projected to grow and federal interest spending is expected to follow. Indeed, interest is slated to be the fastest growing part of the budget over the next decade.

Given the role that interest will contribute to the United States' substantial fiscal challenges, interest costs cannot be treated as merely a side effect in the budget. Even under current projections, interest spending threatens to crowd out other important priorities, and our high level of debt puts the country's finances at substantial risk if interest rates rise further than expected.

Figure 1: Change in Spending 2015 to 2025

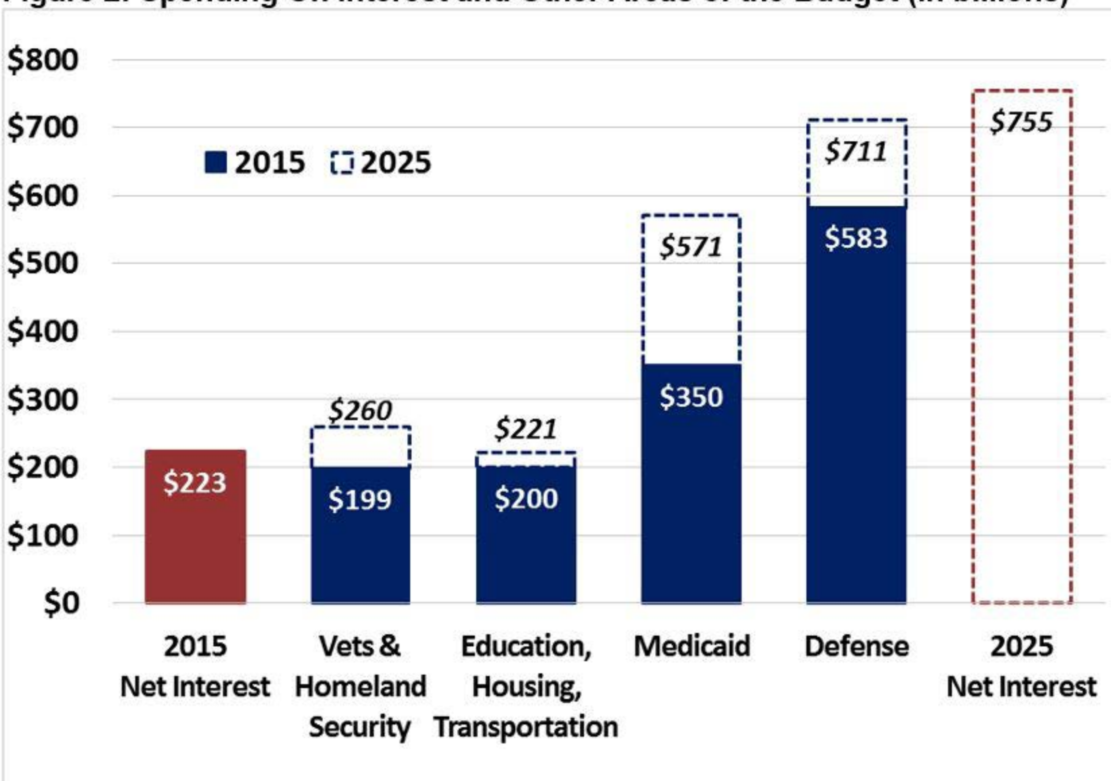


Source: CBO August 2015 Baseline, September 2015 Monthly Treasury Statement

The Current Costs of Interest on the Debt

The $223 billion in interest costs this year resulted from servicing the $13.1 trillion debt at an average interest rate of 1.7 percent. Even at today's record-low interest rates, this is already more than we spend on the Departments of Homeland Security and Veterans Affairs combined. This is also more than our combined spending on the Departments of Education, Housing and Urban Development, and Transportation. Every dollar the United States devotes to interest payments is a dollar that cannot fund national priorities or that

Figure 2: Spending On Interest and Other Areas of the Budget (in billions)



Source: CBO August 2015 Baseline, September 2015 Monthly Treasury Statement

Projections of Interest on the Debt

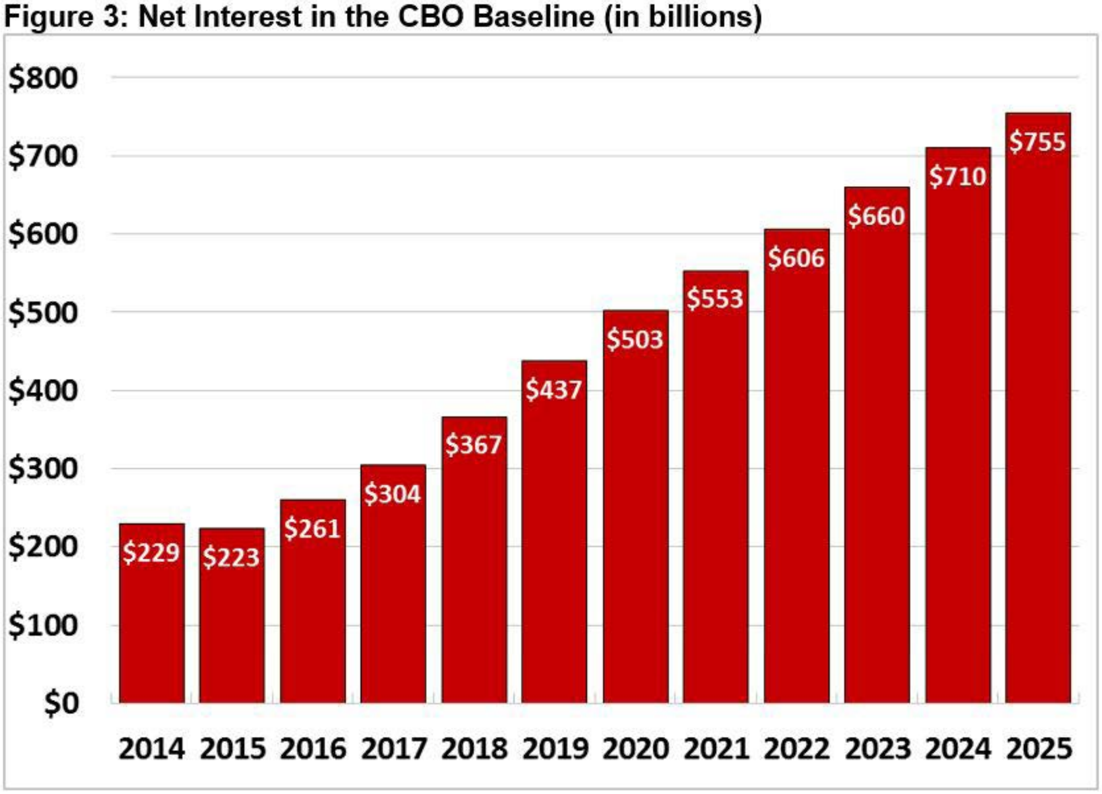
As interest rates rise back to more normal levels and debt continues to grow, the Congressional Budget Office (CBO) expects spending on debt service to increase significantly.

CBO projects the 10-year Treasury note interest rate to increase from about 2.3 percent today to an average of 4.3 percent after 2020 and the interest rate on 3-month Treasury bills to increase from about 0.25 percent in today to 3.4 percent after 2020. CBO also projects debt held by the public will grow from $13.1 trillion at the end of fiscal year 2015 to $21.0 trillion by 2025. As a result of these factors, interest payments will rise.

Based on CBO's August baseline (which excludes some recently-passed legislation):

- In nominal dollars, net interest costs will nearly double between 2015 and 2019 from roughly $220 billion to nearly $440 billion; by 2025 interest costs will have more than tripled to $755 billion.
- As a share of the economy, federal interest payments are expected to double by 2021, from 1.2 to 2.4 percent of GDP, and then continue to grow to 2.8 percent of GDP by 2025.
- The annual budget deficit will rise from $439 billion in 2015 to $1.0 trillion in 2025. This can is almost entirely explained by the $532 billion rise in interest payments.
- By 2022, interest payments will surpass how much the government spends on all of its investments, including research and development, education, training, and infrastructure.
- By 2025, interest payments will consume 15% of all revenue collected and represent 1 out of every 8 dollars the government spends.

Figure 3: Net Interest in the CBO Baseline (in billions)



Source: CBO August 2015 Baseline, September 2015 Monthly Treasury Statement

What if Interest Rates Differ from Projections?

CBO expects interest rates to rise, but not to their pre-crisis levels. As a result of slower labor force and productivity growth, growing income inequality, and other factors, CBO projects rates (on an inflation-adjusted basis) will be about one percentage point lower than the average between 1990 and 2007. If interest rates differ from CBO's projections, the budgetary implications could be significant.

For example:

- If real interest rates return to pre-crisis levels, interest payments over the next decade would be \$1.7 trillion higher – increasing debt in 2025 by 6 percent of GDP.
- If real interest rates returned to pre-crisis level, debt held by the public would exceed the size of the economy by 2033.
- If real interest rates returned to the levels seen in the 1980s, interest payments would be \$6 trillion higher, increasing debt in 2025 by 22 percent of GDP.
- Conversely, if real interest rates remain around the levels we've seen over the past 10 years, deficits and debt over the next decade would be \$1.6 trillion lower.

Figure 4: Interest Rate Scenarios and Their Effect on Future Deficits (2016-2025)

	Deficit Impact (billions)	Debt in 2025 (% of GDP)
Interest rates rise to projected levels by 2017 instead of 2021	\$220	78%
Interest rates return to 1996-2007 average (1/2 p.p. higher than baseline)	\$850	80%
Interest rates return to 1990-2007 average (1 p.p. higher than baseline)	\$1,700	83%
Interest rates return to 1980's average (3 1/3 p.p. higher than baseline)	\$6,000	99%
Interest rates return to 2005-2014 average (1 p.p. lower than baseline)	-\$1,600	71%
Memo: CBO August baseline debt held by the public	*N/A*	*77%*

Source: Rough CRFB calculation based on Congressional Budget Office, Federal Reserve, Bureau of Labor Statistics Data
Notes: Interest rate changes are applied across-the-board to all Treasury debt securities. Estimates are rounded. Baseline refers to CBO's August Baseline

Conclusion

With the help of historically low interest rates, this year's deficits are significantly lower than just a few years ago. However, trillion-dollar deficits are poised to return as interest rates rise over the next decade. And without a plan to reduce debt levels from their current historic highs, even small increases in interest rates beyond projected levels could significantly worsen an already unsustainable fiscal picture. The best way policymakers can protect against the risk of rising interest rates is to enact a thoughtful mixture of tax and spending reforms that put the debt on a clear downward path over the long run.