The Coming Fiscal Crisis

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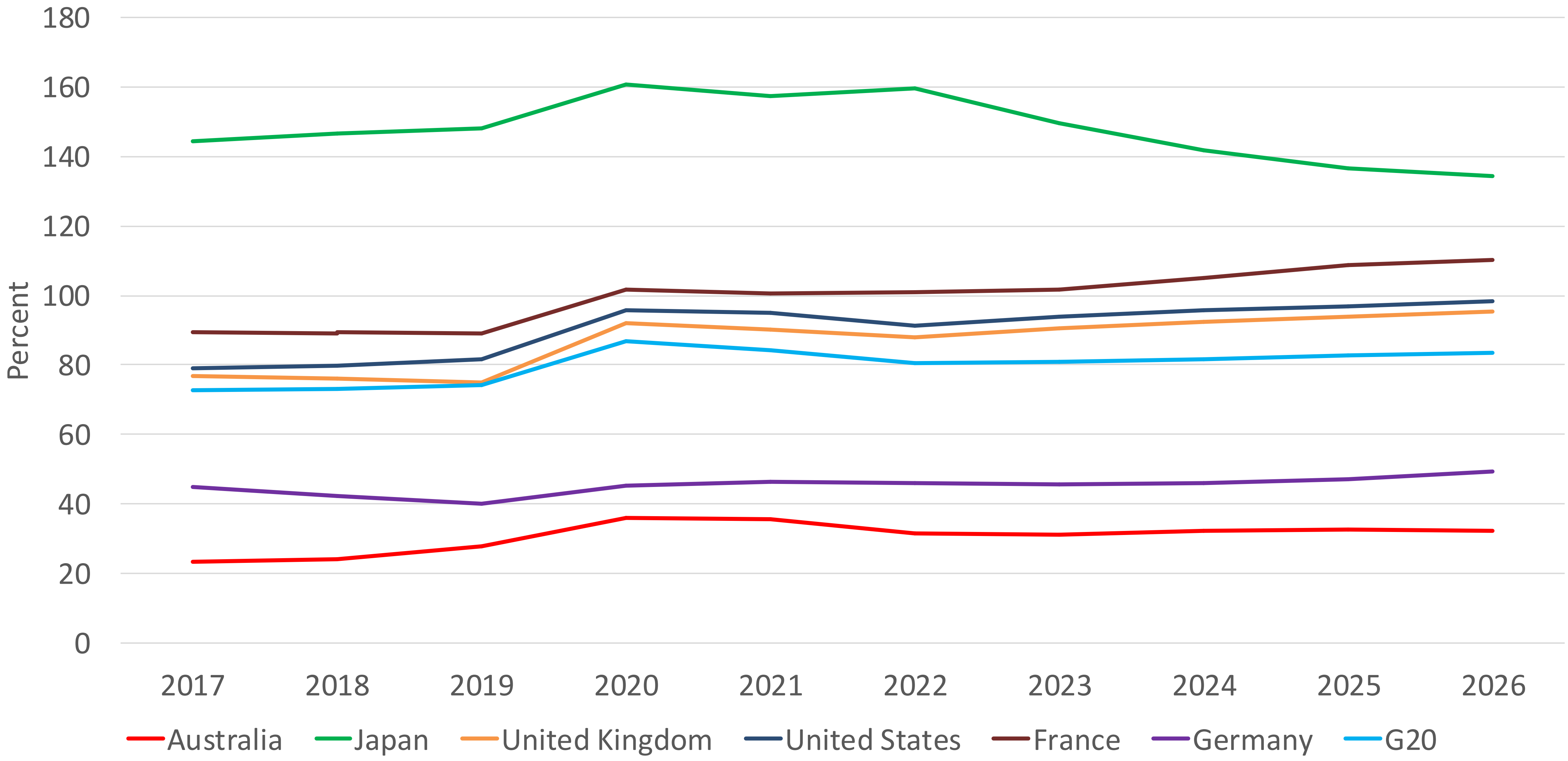
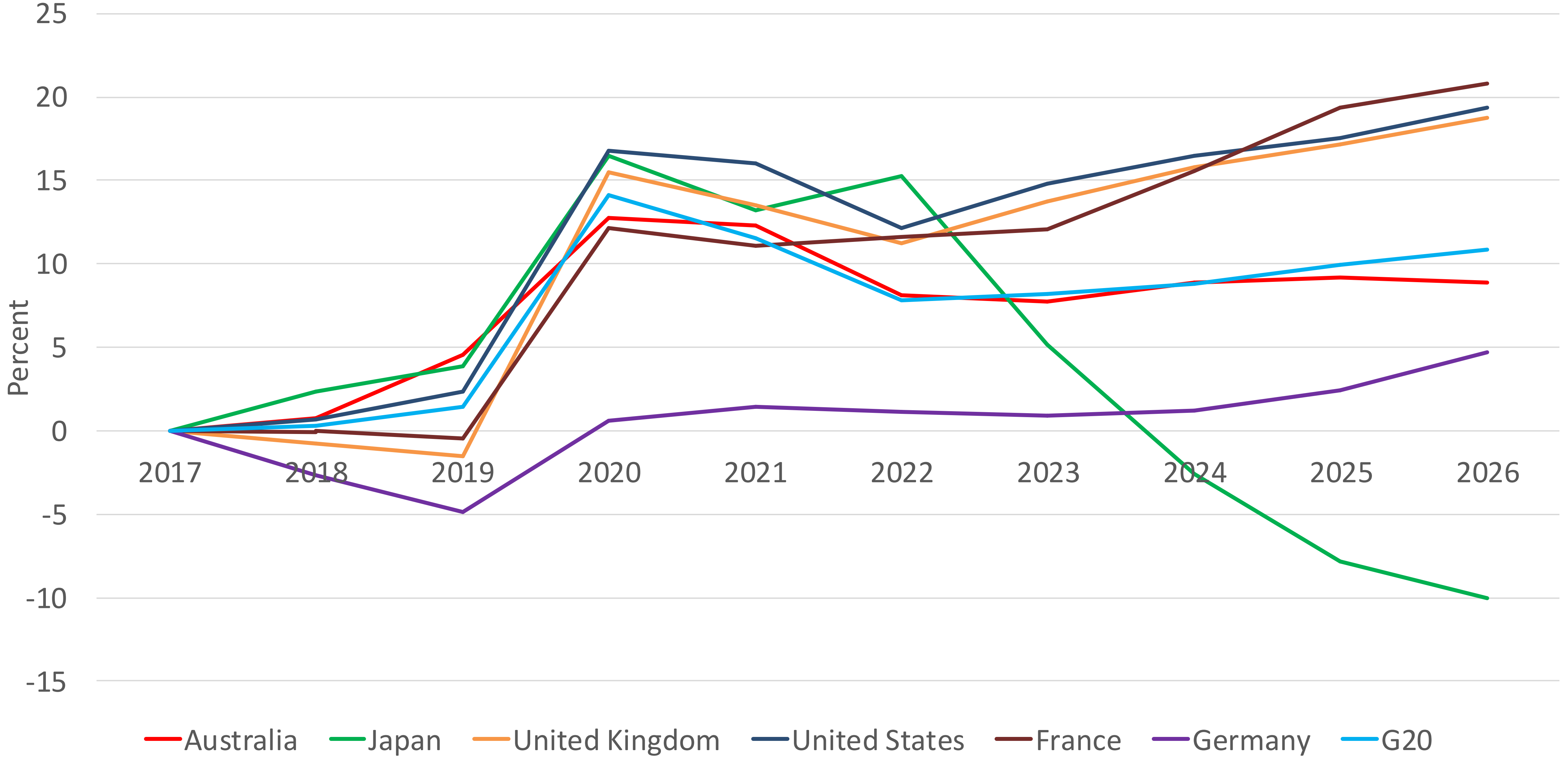
July 20, 2026

Net Debt-GDP Ratio



Source: IMF Fiscal Monitor

Change in Net Debt-GDP Ratio Since 2017



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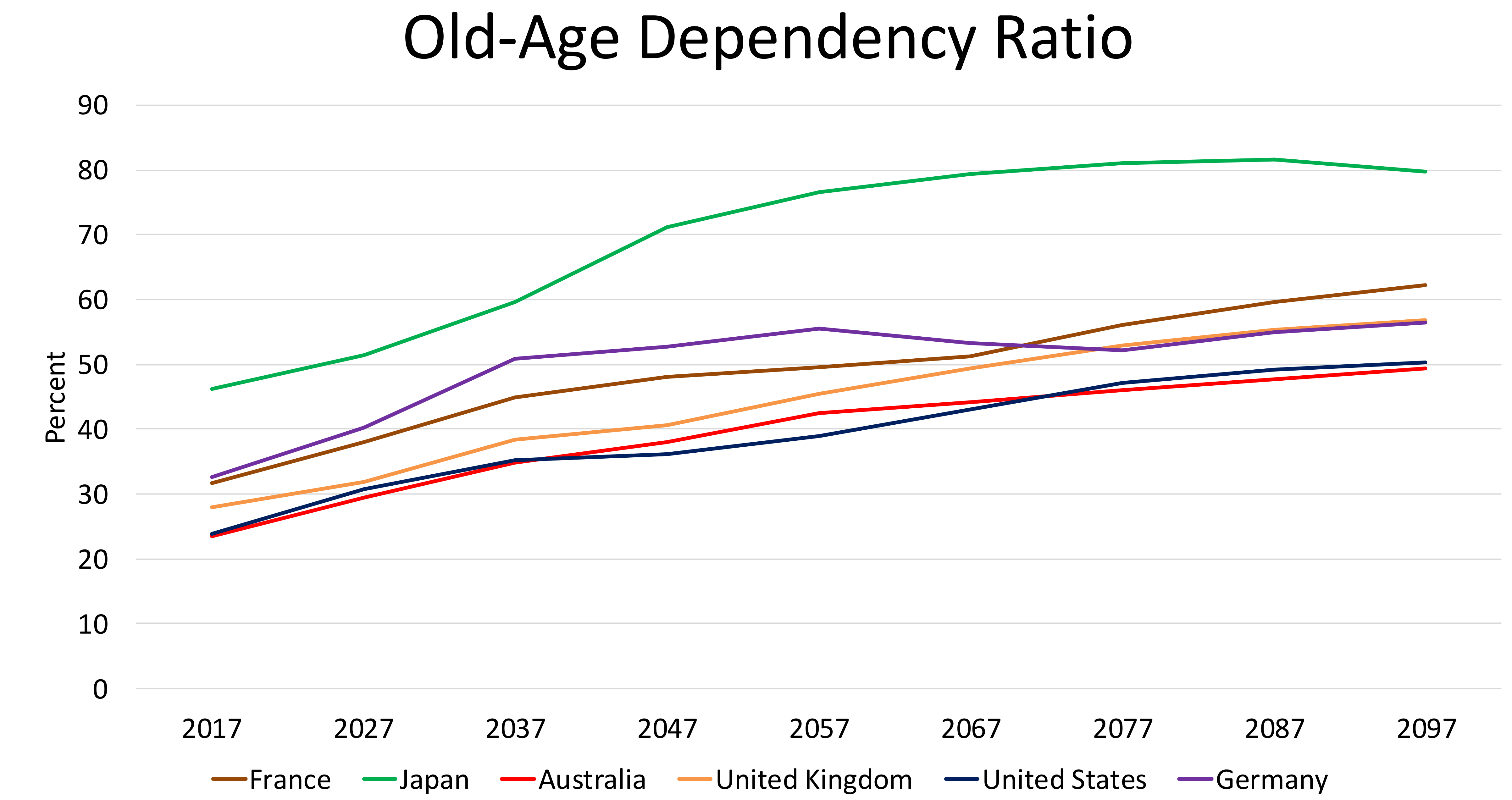


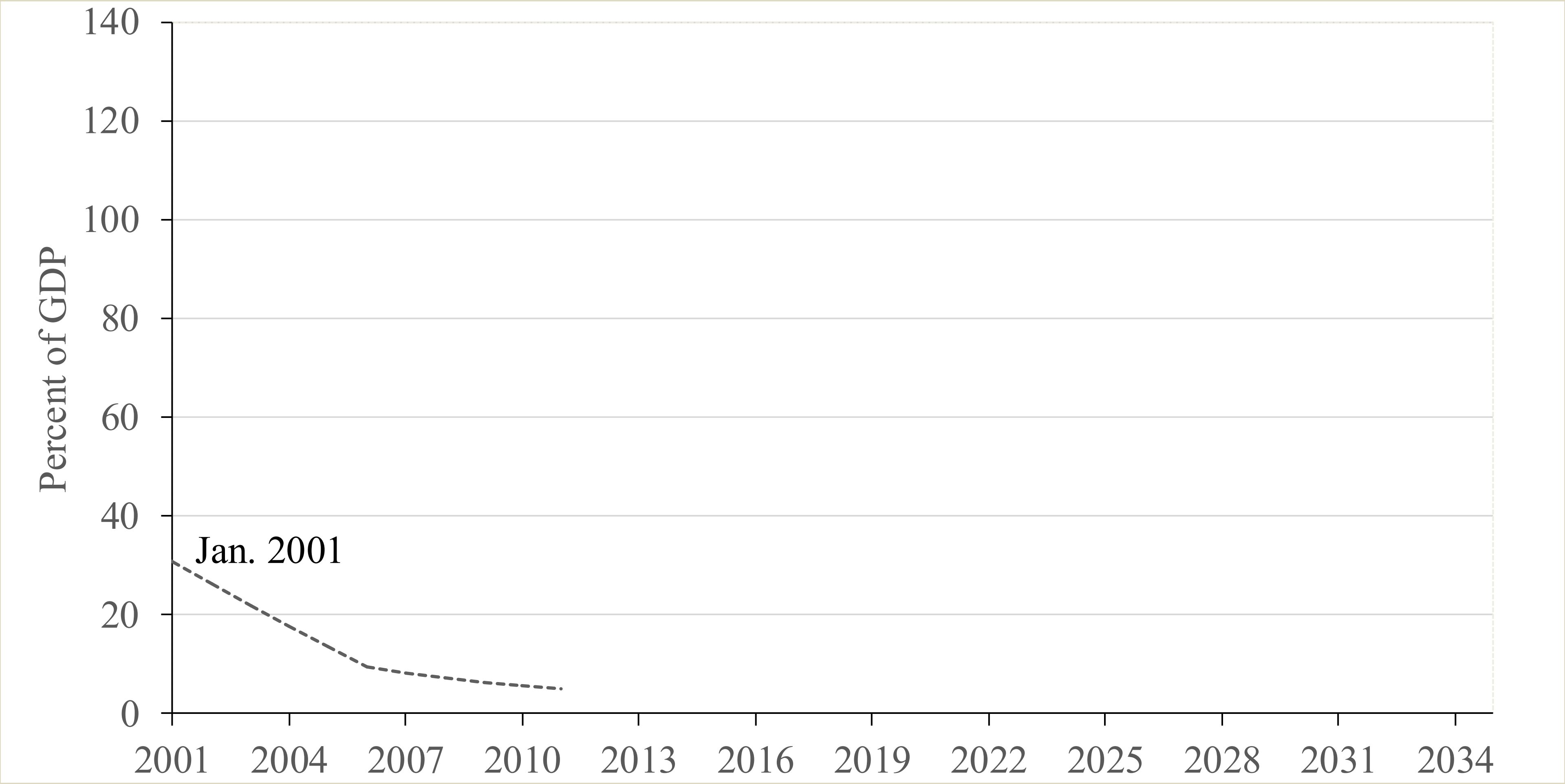
Source: United Nations Population Division

Rising Debt and Increasing Dependency Ratios

- Why is debt increasing?
- What will its effects be?
- How will the story end?

- To gain insight, consider the United States as a case study

CBO Baseline Debt Projections over Time



Source: Auerbach and Gale (2025)

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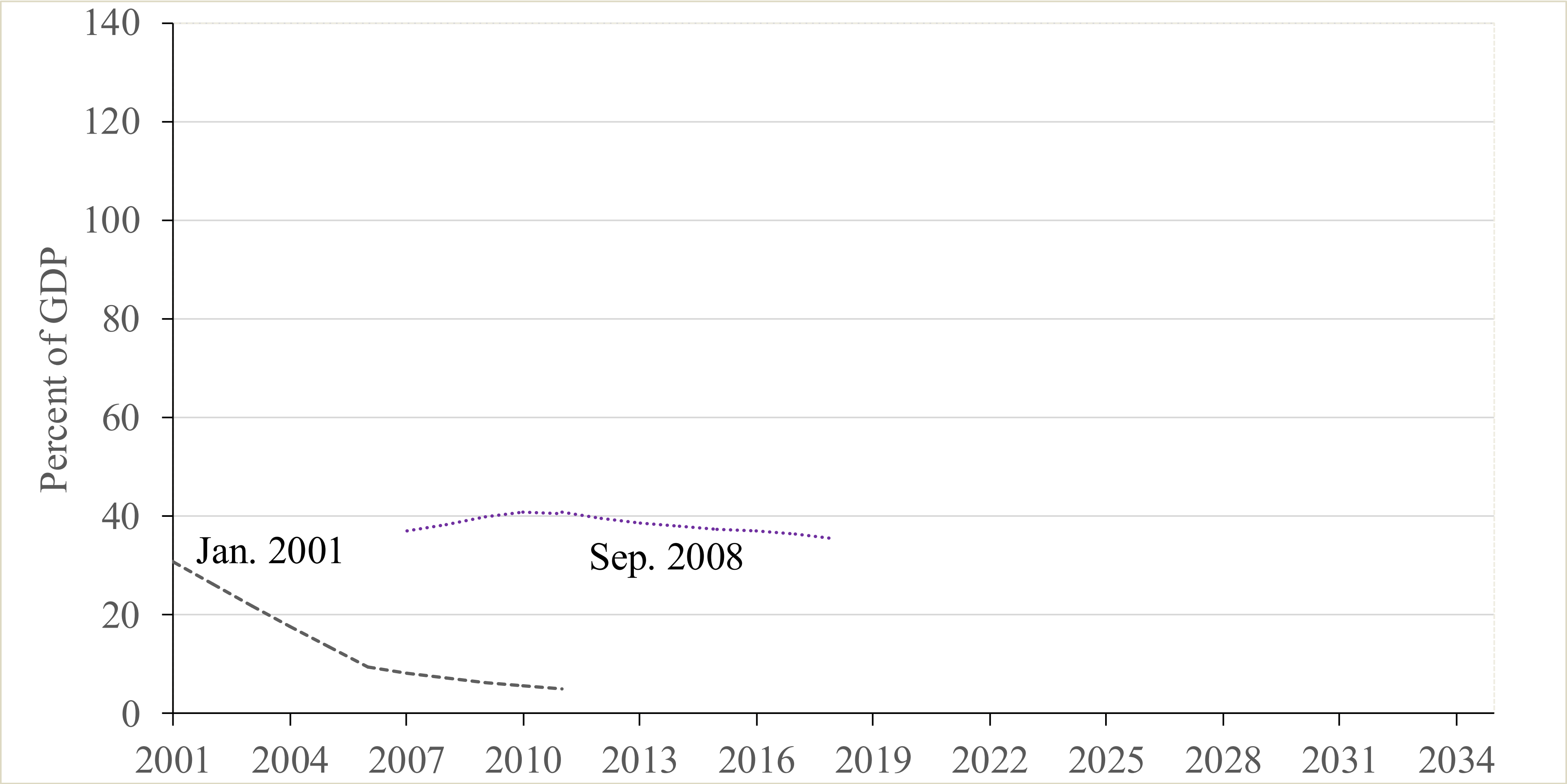

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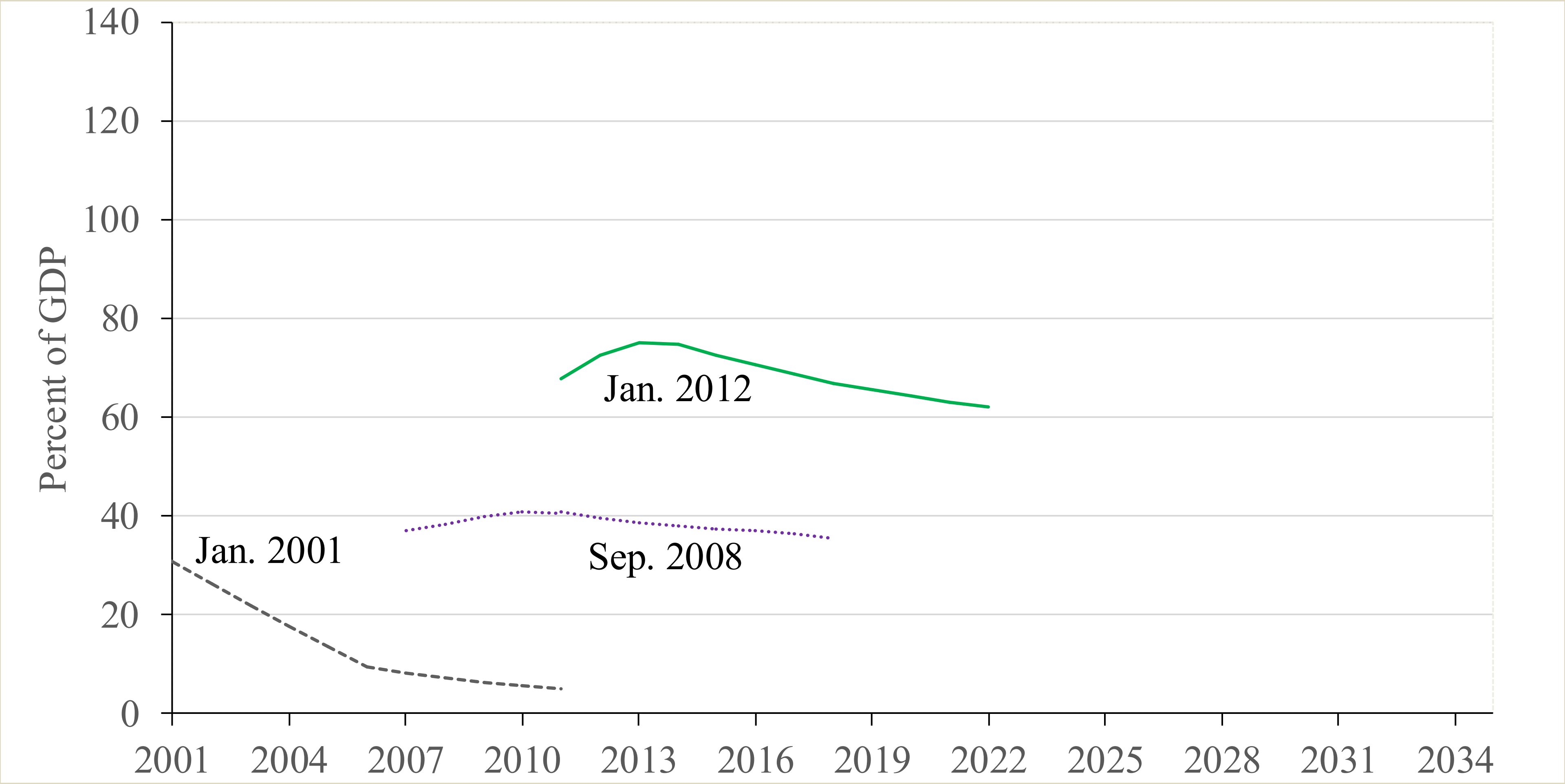

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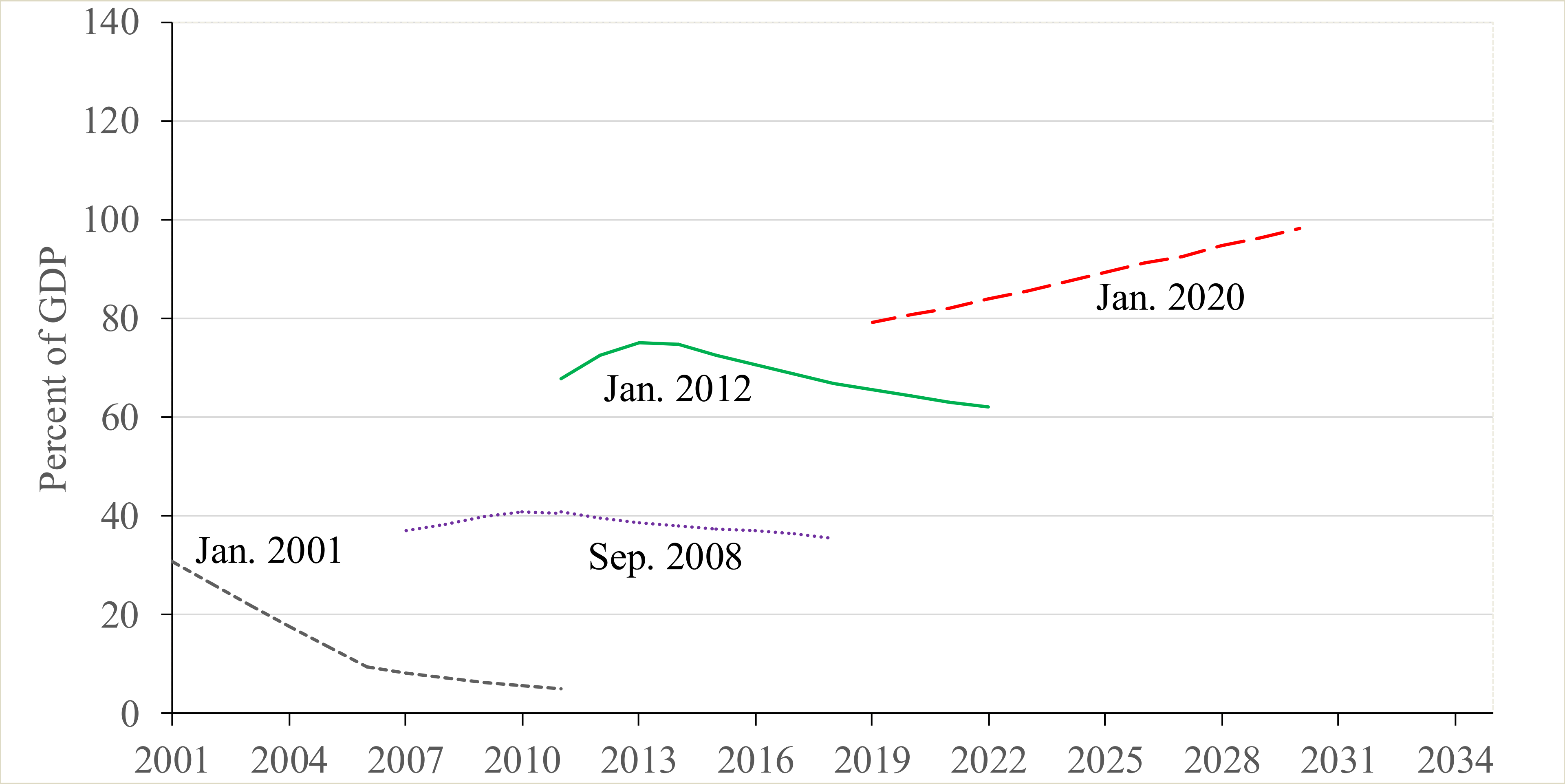

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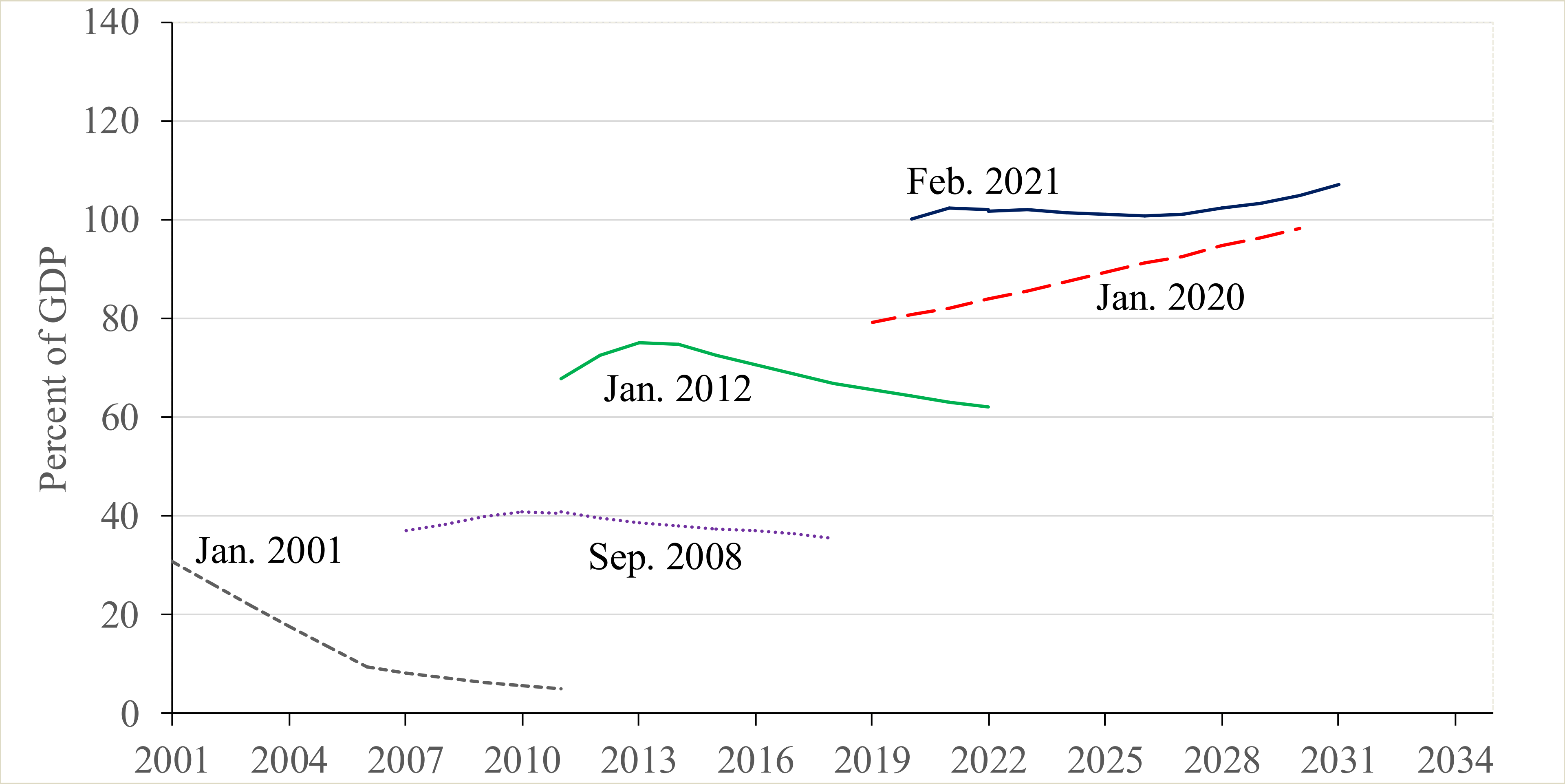

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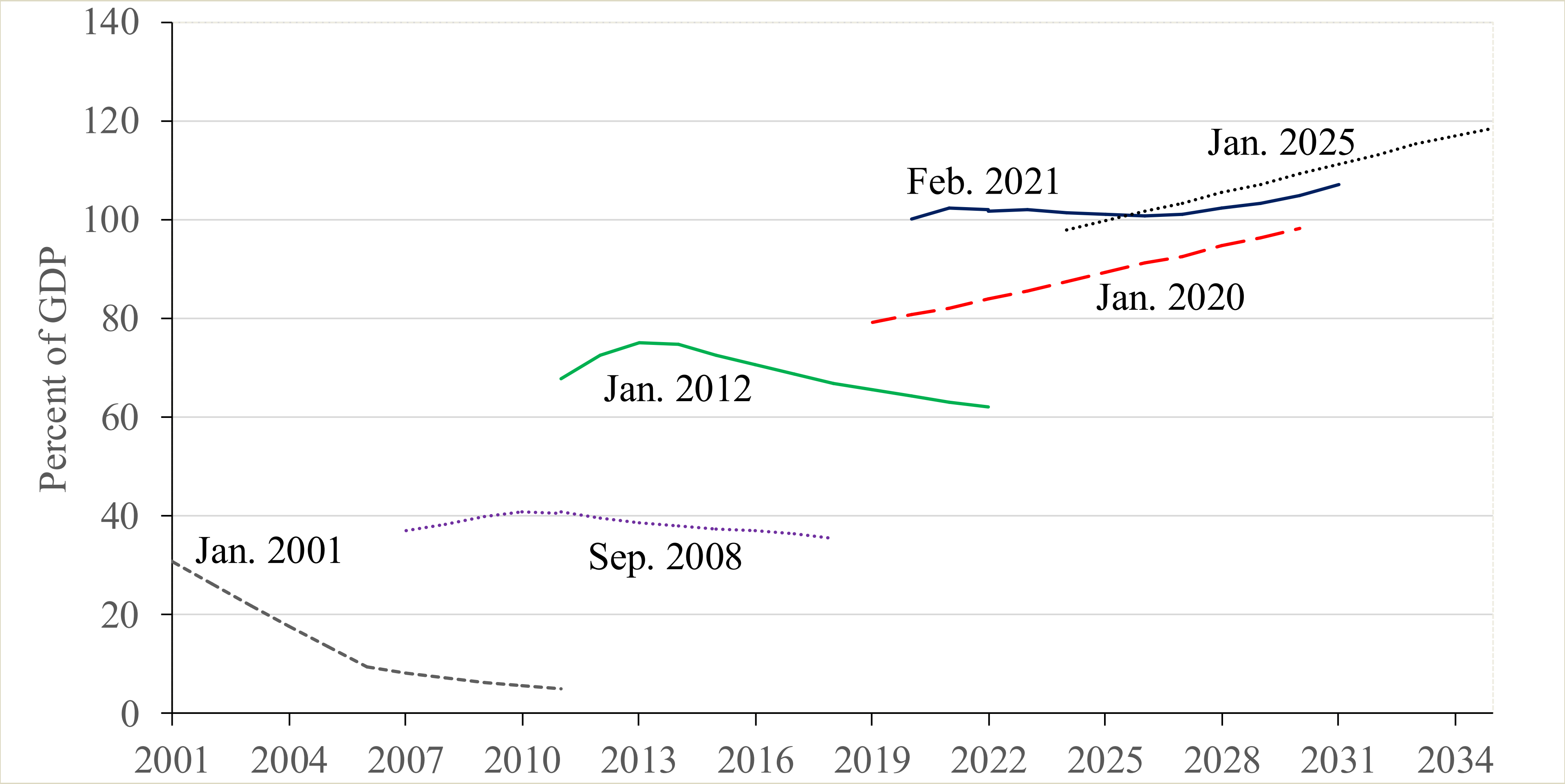
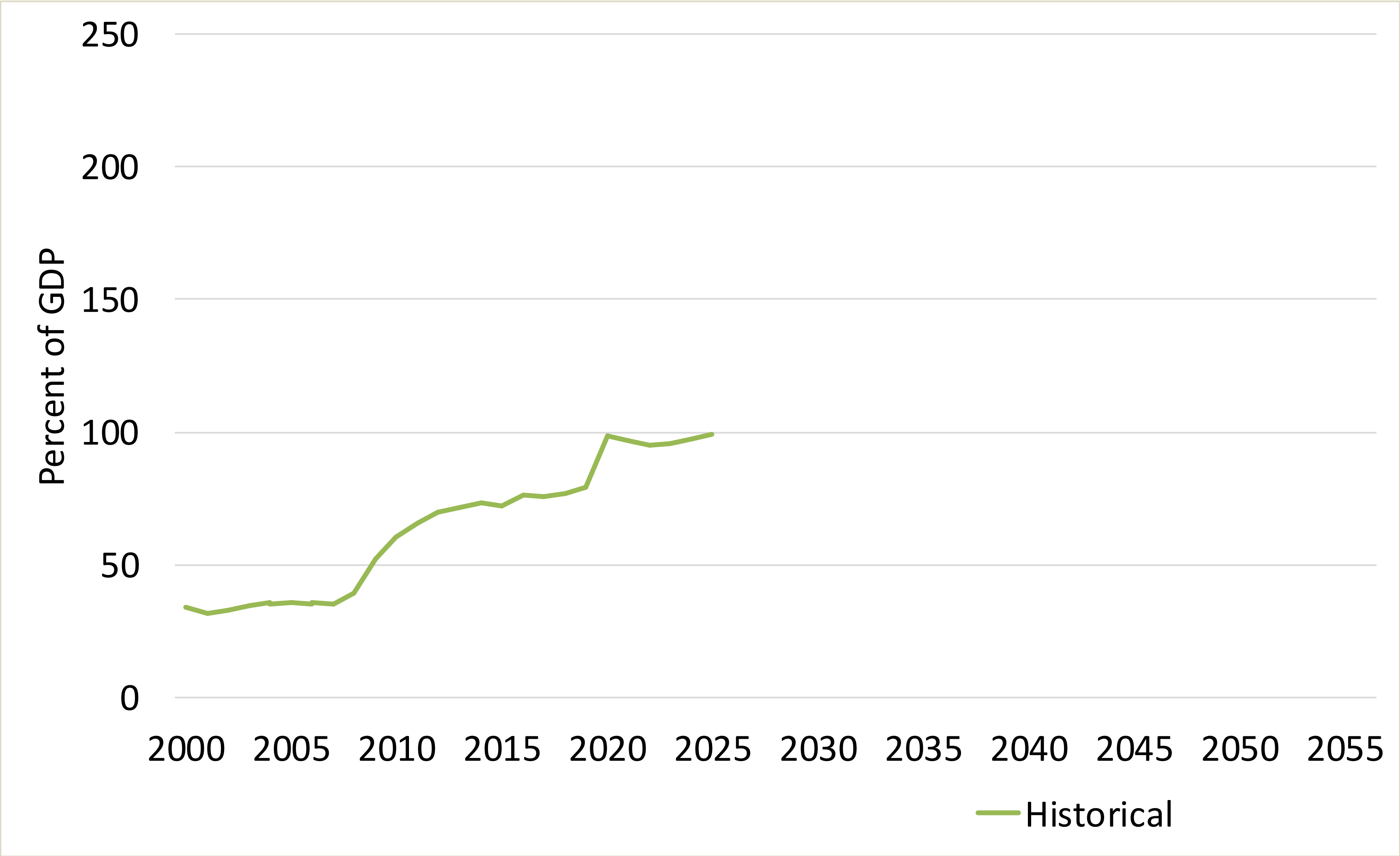


Source: Auerbach and Gale (2025)

Public Debt, 2000 - 2056



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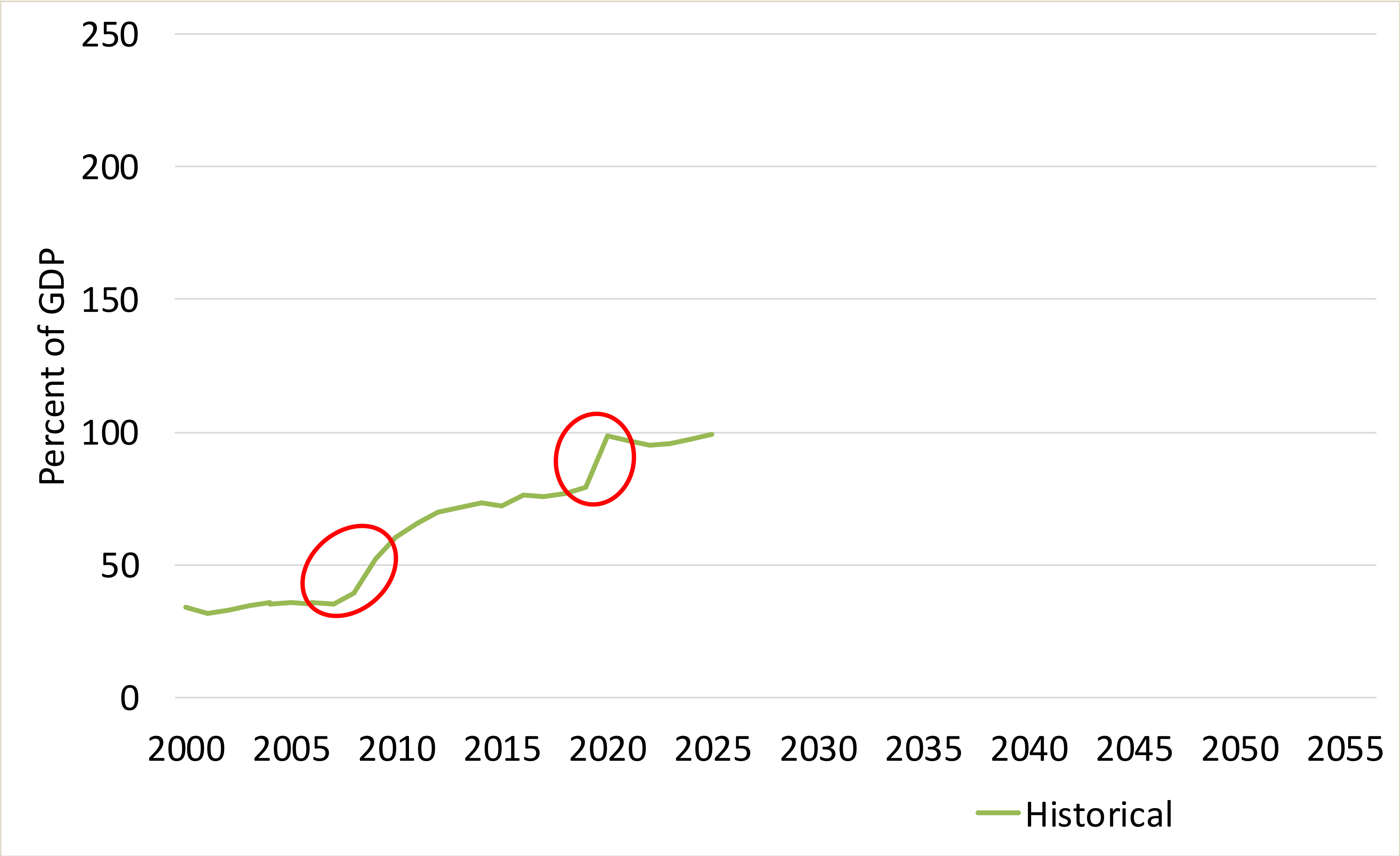

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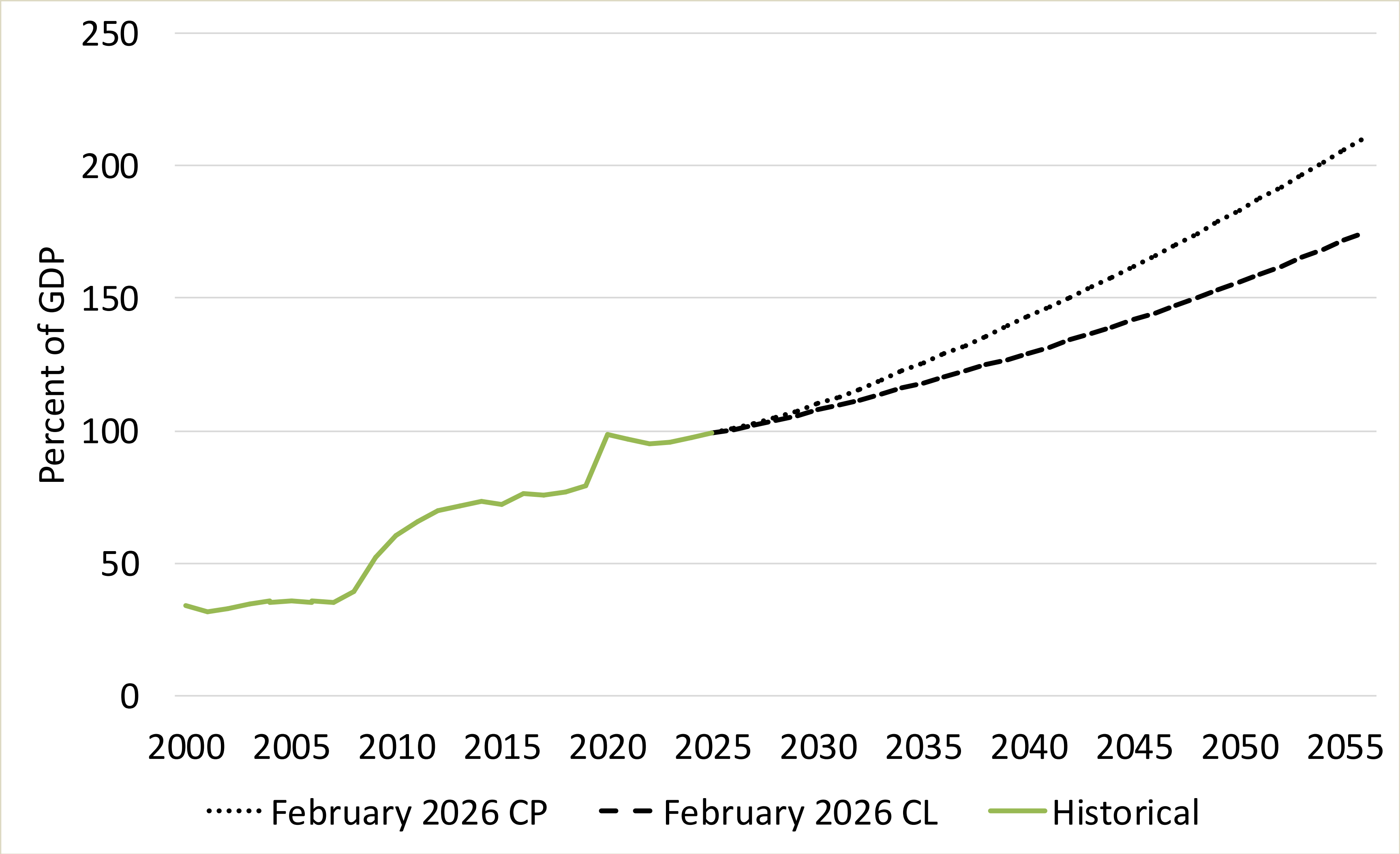
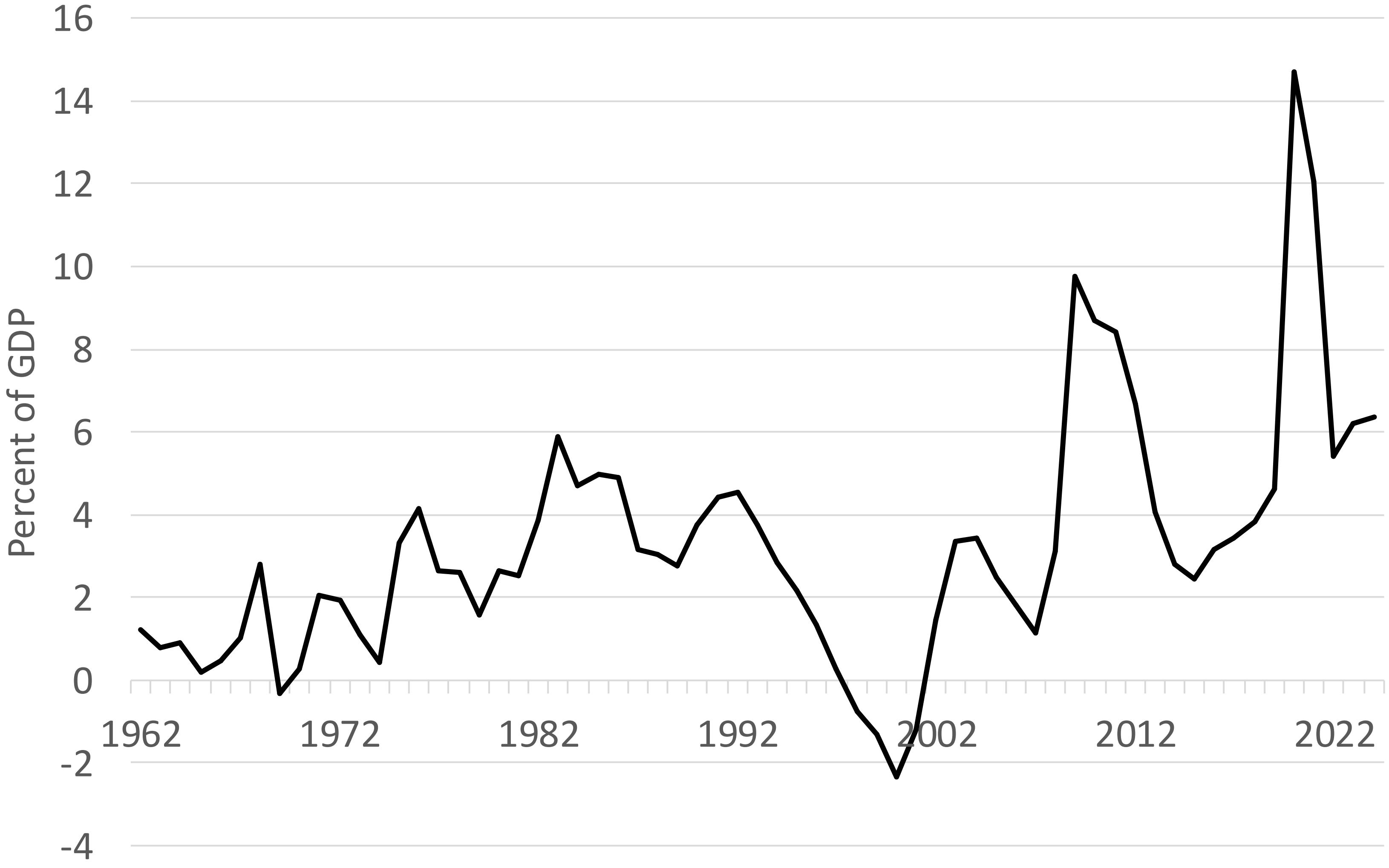


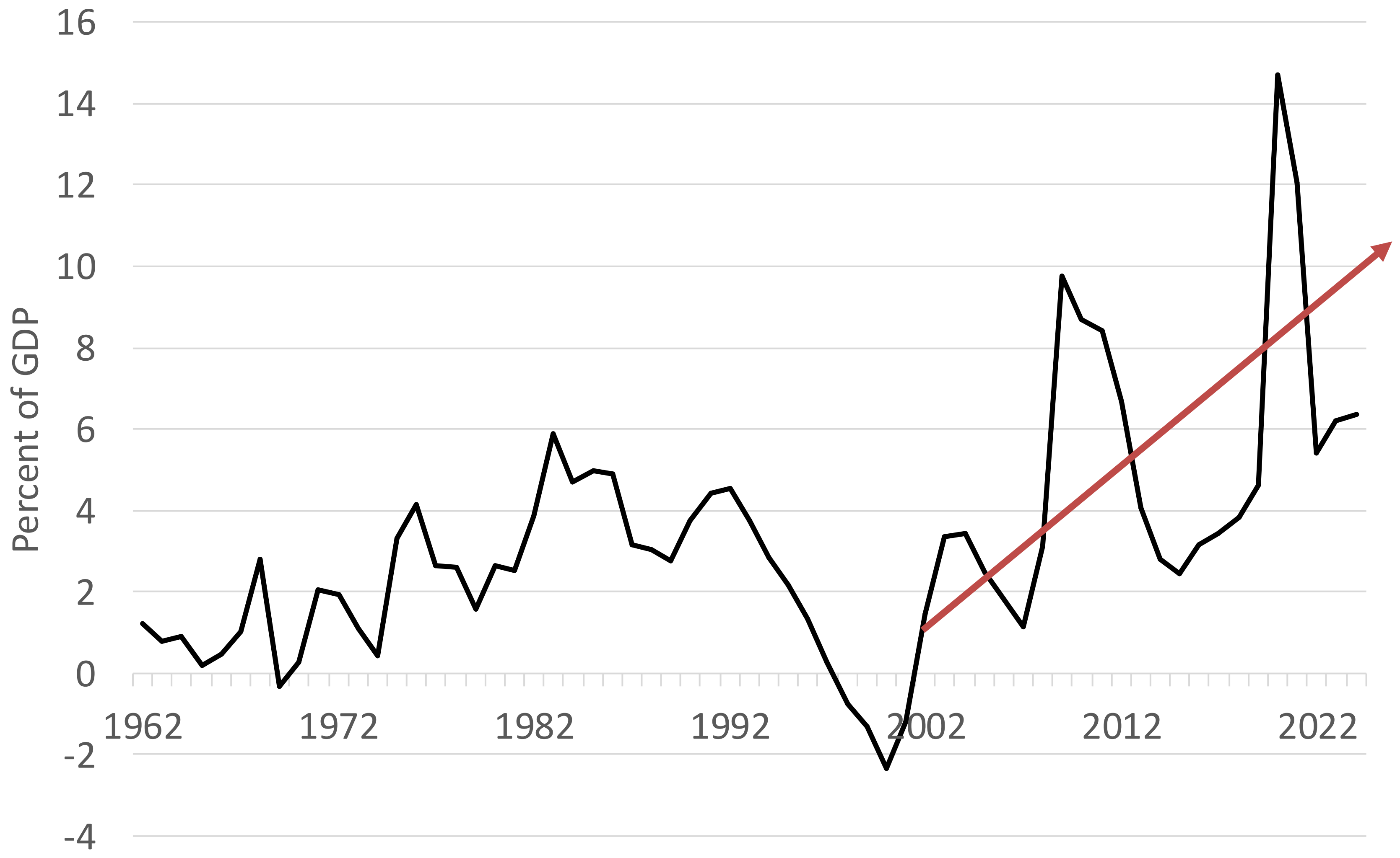
Source: Auerbach and Gale (2026)

Budget Deficits since 1962



Source: Auerbach and Gale (2025)

Budget Deficits since 1962



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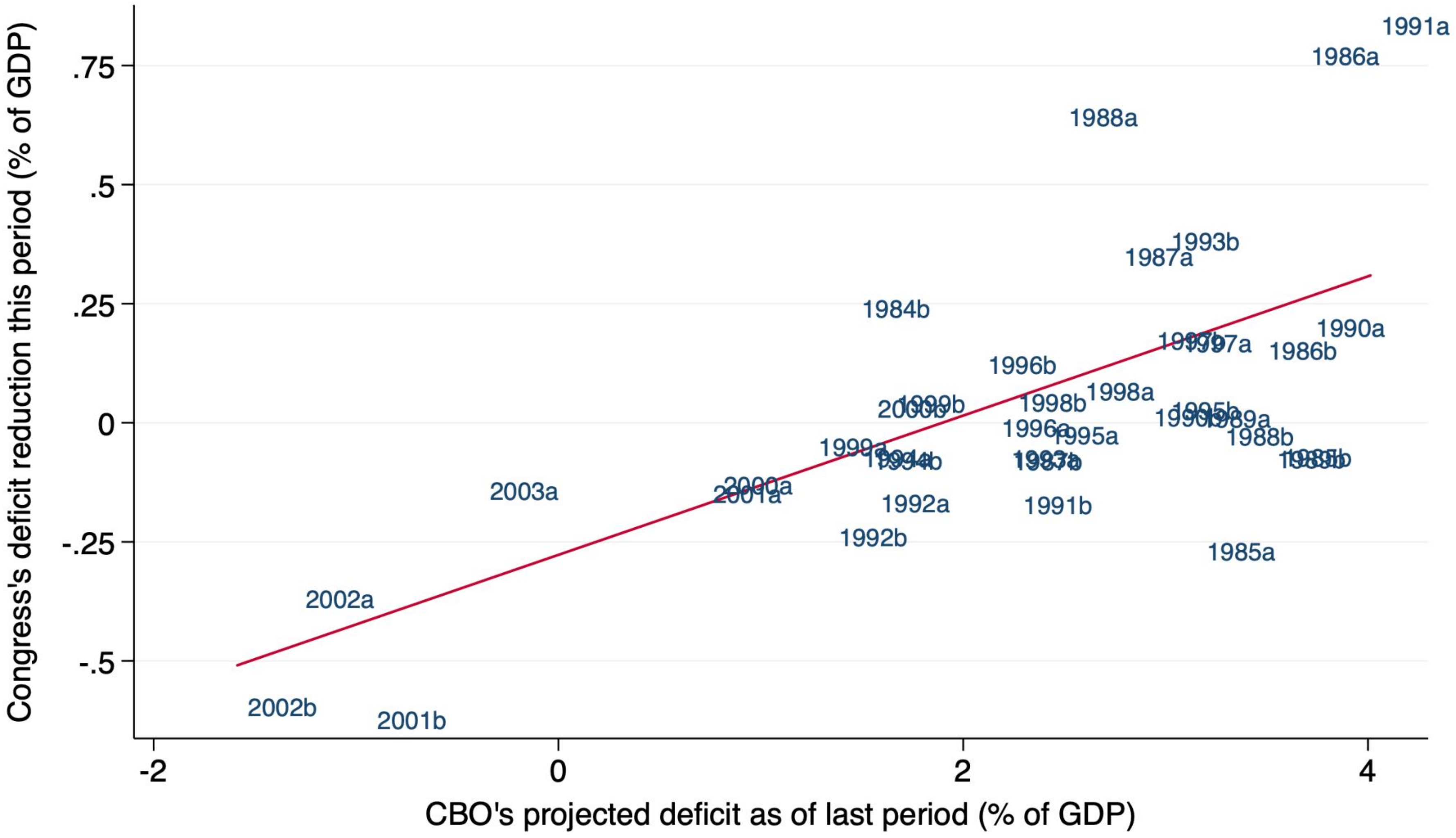
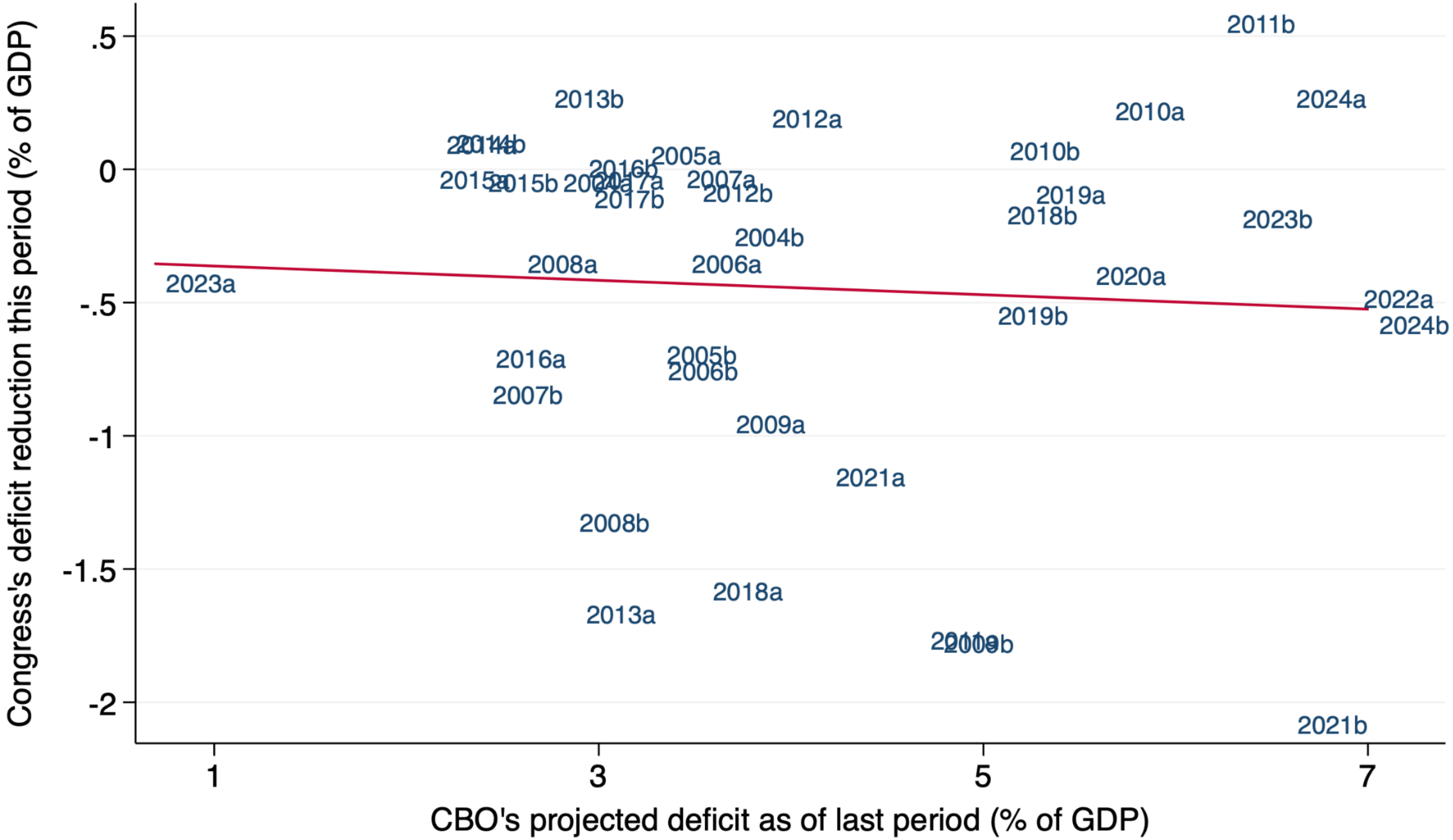
Legislative Responses to Prospective Deficits, 1984-2003



Source: Auerbach and Yagan (2025)

Legislative Responses to Prospective Deficits, 2004-2024



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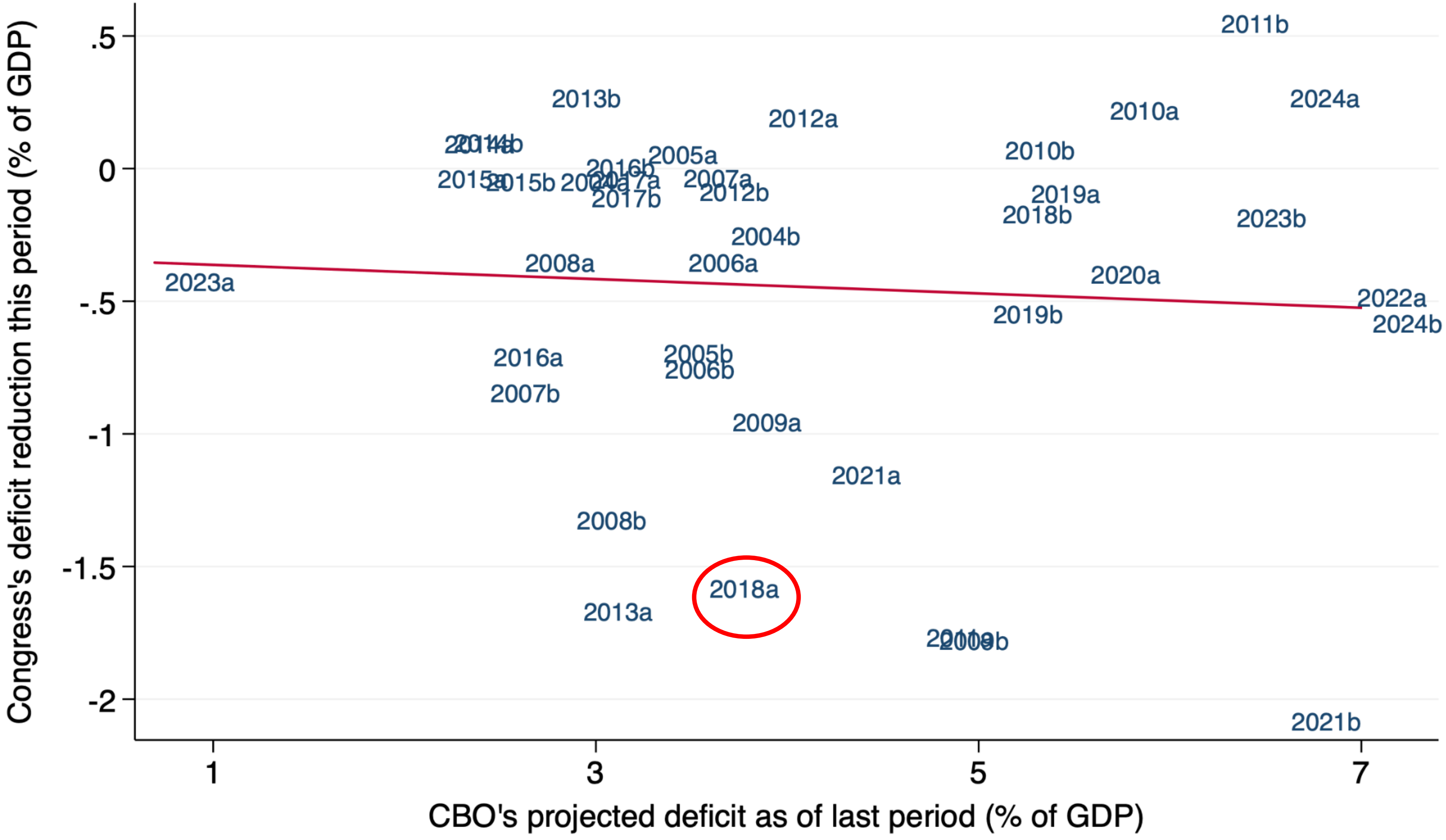

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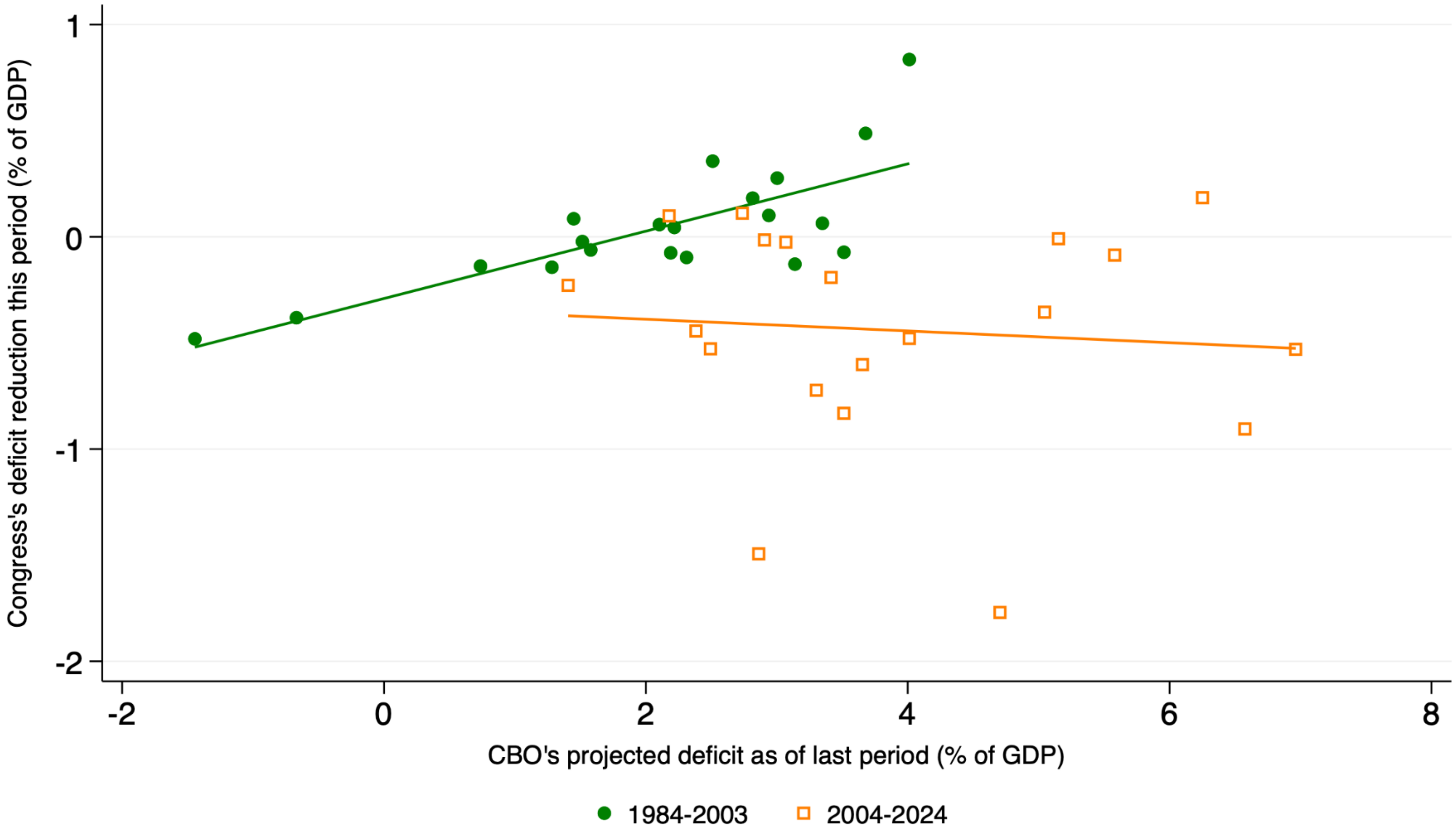
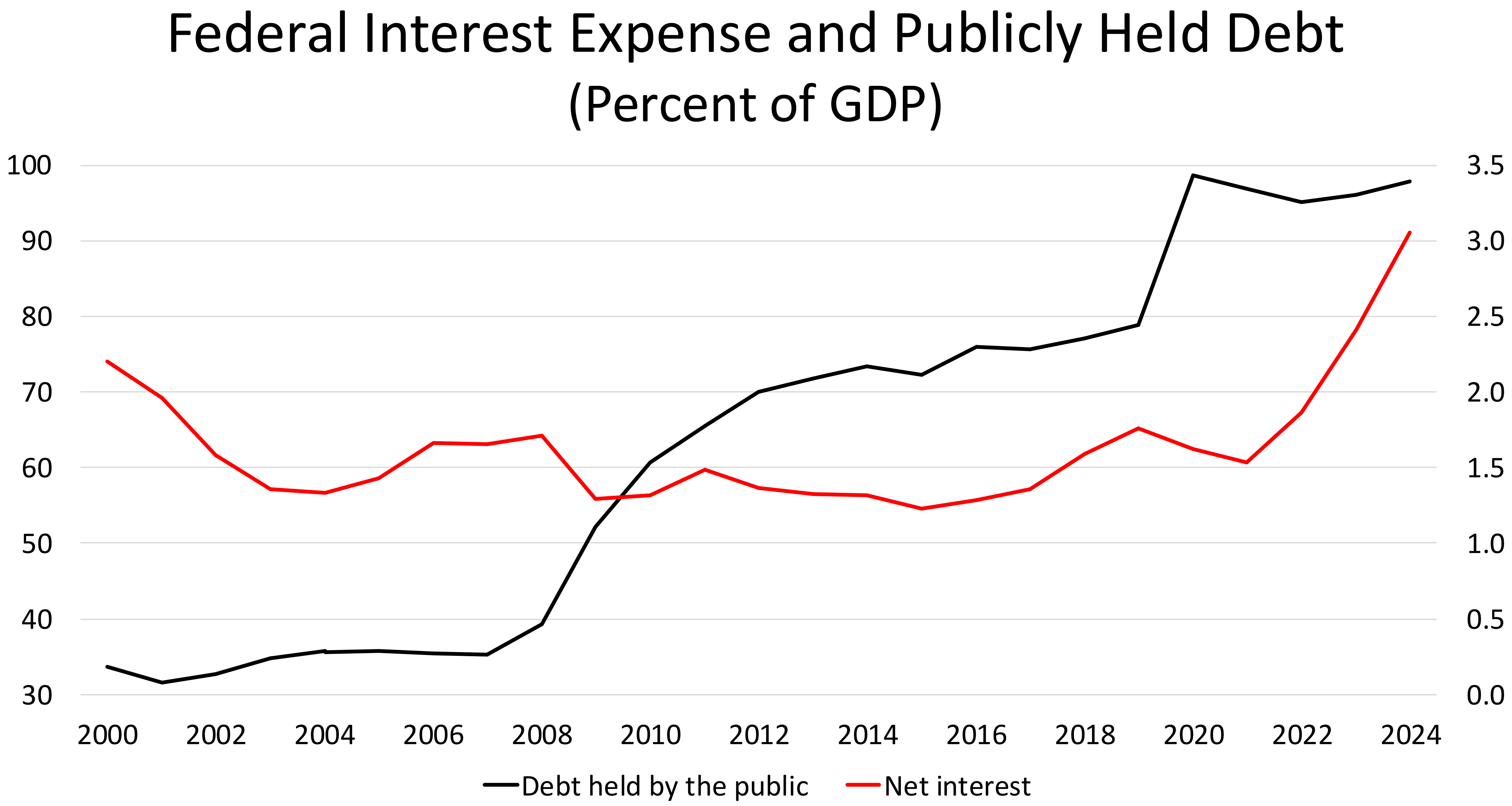


Source: Auerbach and Yagan (2025)

Possible Explanations

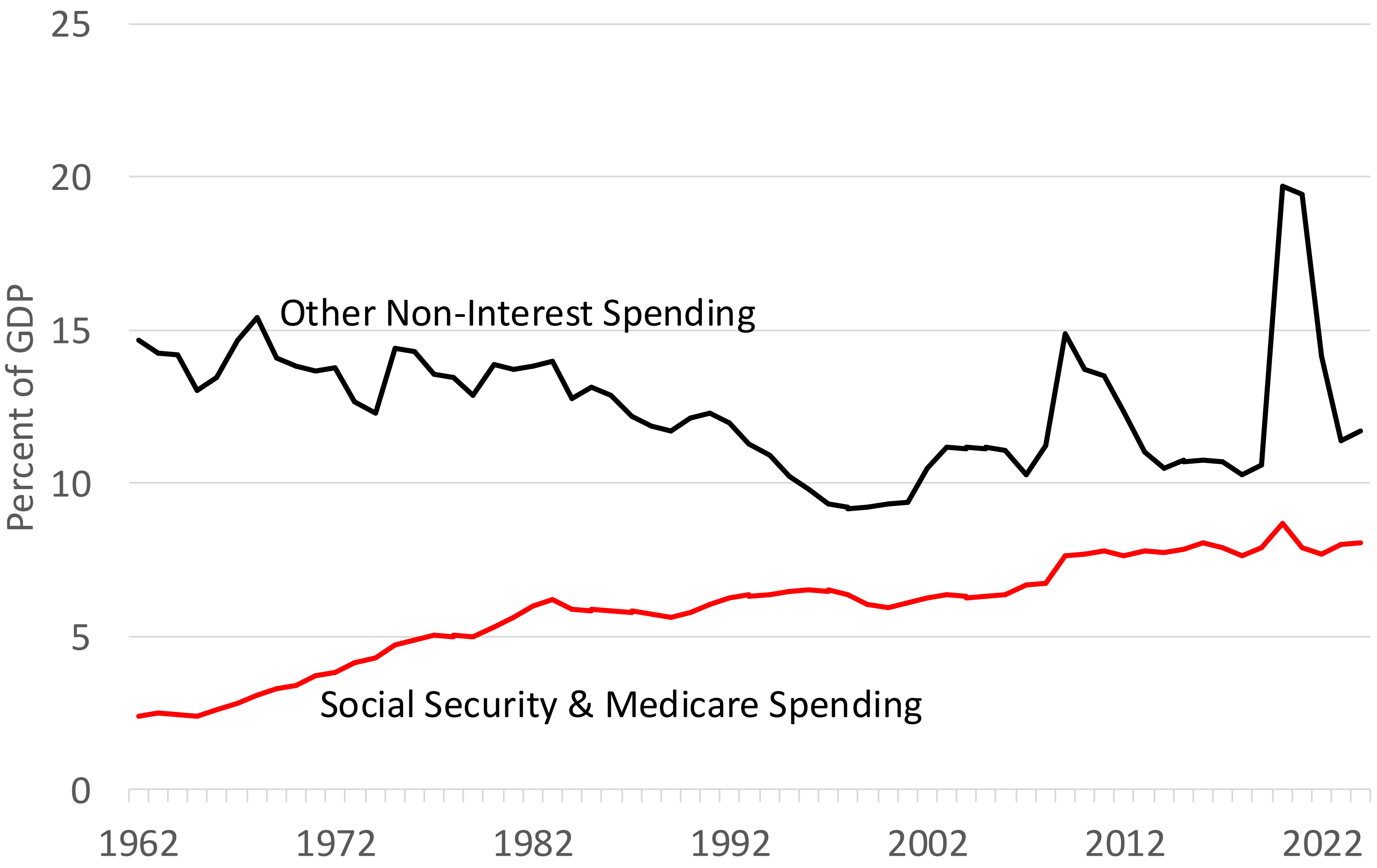
- Political polarization
- Low interest rates


Federal Interest Expense and Publicly Held Debt
(Percent of GDP)
100
90
80
70
60
50
40
30
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
2024
Debt held by the public
Net interest

Possible Explanations

- Political polarization
- Low interest rates
- Growth in old-age entitlement spending

Components of Federal Spending

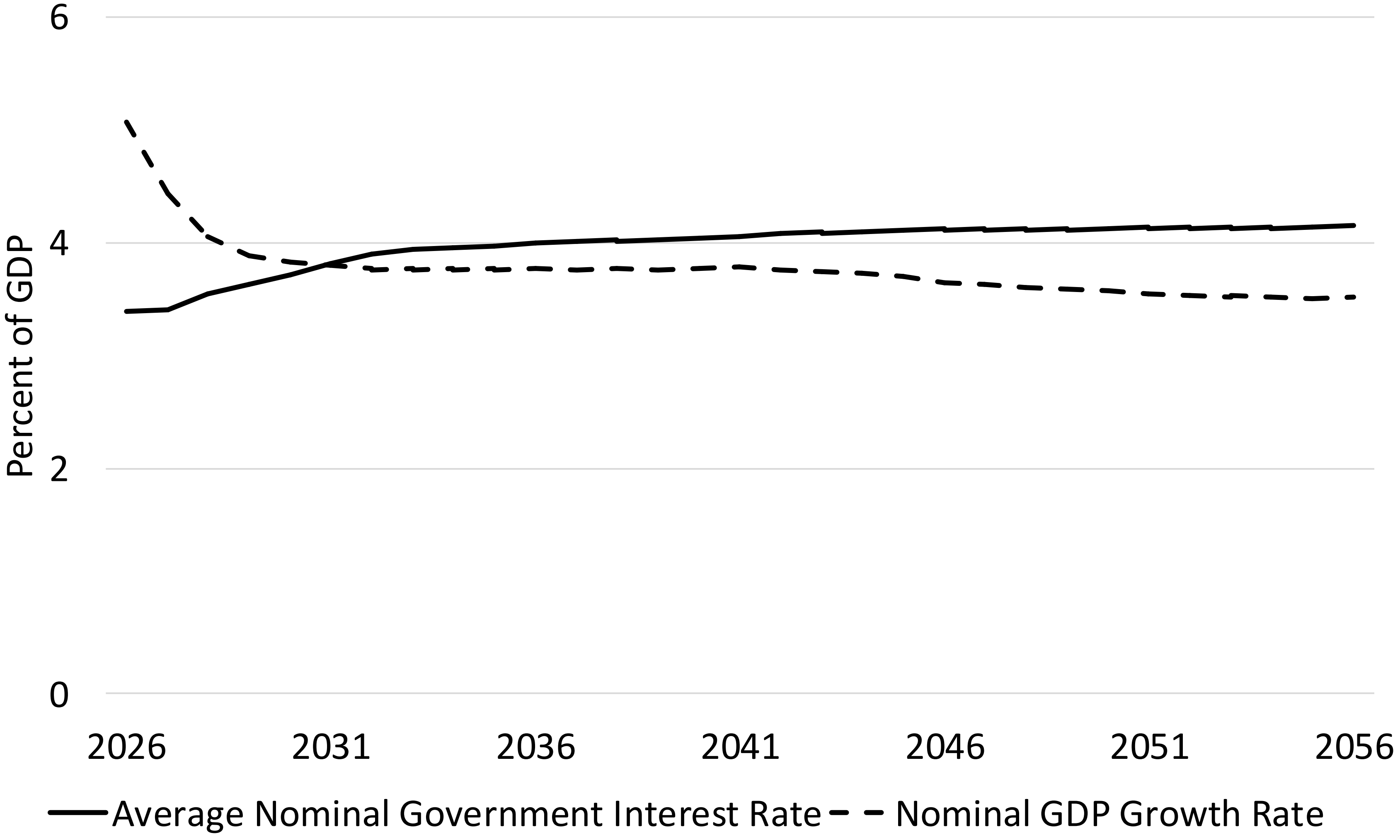


Source: Auerbach and Gale (2025)

Looking Ahead

- Large deficits persist, leading to projected continued debt-GDP growth
- Favorable interest rate experience is likely over

Interest and Economic Growth Rates



Source: Auerbach and Gale (2026)

What is Needed for U.S. Fiscal Sustainability?

- Take account of stochastic shocks to interest rates and budget and responsiveness of interest rates to debt based on historical patterns
- Define sustainability as maintaining a debt-GDP ratio below 250% over the next 100 years, for at least 95% of outcomes
- Estimate how strong annual deficit feedback has to be to achieve sustainability
- Auerbach and Yagan (2026): legislation should reduce deficit by 0.28% of GDP immediately, and 1.70% over next ten years

Is U.S. Fiscal Sustainability Achievable

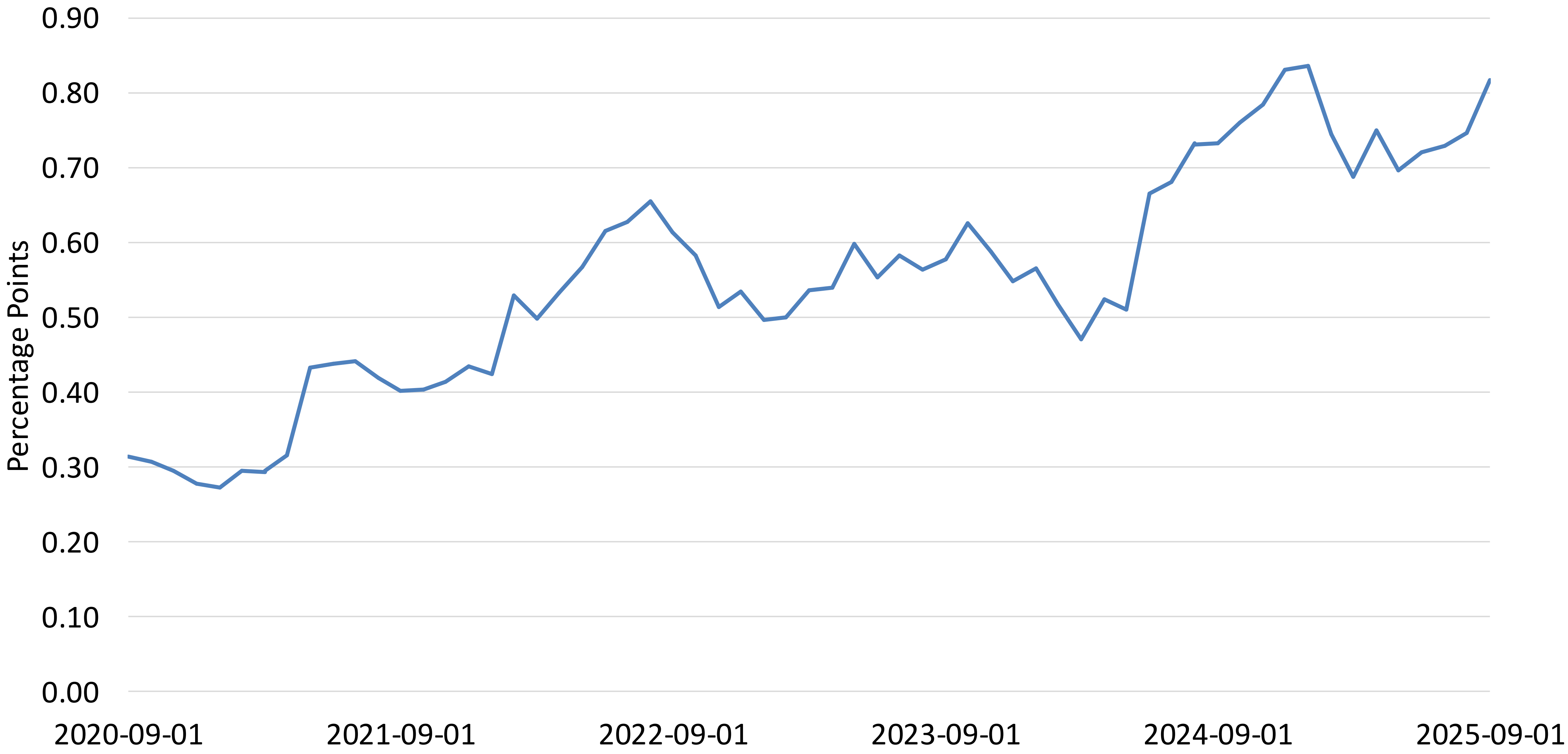
- Since early 1980s largest U.S. multiyear fiscal consolidation was roughly 2% of GDP in mid-1980s, so 1.7% is feasible, based on past practice
- But the U.S. economic and political environment is now very different than in the mid-1980s, so likelihood of the needed fiscal consolidation is very unlikely, without some sort of U.S. fiscal crisis

What Might a U.S. Fiscal Crisis Look Like?

Two possibilities

- Sudden loss of access to borrowing
  - Extremely unlikely for U.S., given its reserve currency/traditional safe-haven status
- Gradual increase in interest rates, as has been experienced in other countries as their fiscal situation worsened

10 Year Government Yields, France minus Germany



Source: FRED

Additional Concern

- Loss of fiscal space
  - Romer and Romer (*BPEA* 2019): During Covid-19 epidemic, countries with low debt-GDP ratios took more aggressive fiscal actions
  - This was attributable to a combination of greater market access and greater willingness to run fiscal deficits

Possible Solutions to Achieve Sustainability

- Budget Rules
- Fiscal Councils

Budget Rules

- Rules typically place limits on expenditures, revenues, debt, and/or deficits, with “escape clauses”: exceptions permitted for recessions, emergencies, wars, etc.
- Fundamental trade-off between flexibility and credibility
  - Flexibility needed to deal with unanticipated problems
  - More flexibility makes rules less transparent and commitment to controlling debt less credible
- Although some evidence that budget rules have an impact, it is difficult to measure how successful rules have been

Fiscal Councils

- Less ambitious than budget rules, but also broader in scope
- Objective is to improve outcomes through modifications of the budget process and provision of independent information
- Key attributes include
  - Independent forecasts and scoring of policy proposals
  - Monitoring of adherence to fiscal rules
  - Assessment of long-term sustainability
  - Recommended policy actions to improve sustainability
- Budget rules and fiscal councils are not mutually exclusive

Conclusions