Is a fiscal tipping point looming? Key challenges facing the US in the coming years

No. 504, 26. June 2025

Author: Dr Stephan Bales, Phone +49 069 7431-99048, stephan.bales@kfw.de

Under current legislation, US government debt is rising inexorably, interest expenses have tripled since 2020 and the social security system is under increasing pressure. Against this backdrop, the tax cuts enacted in 2017 should be permanently adopted under the “One Big Beautiful Bill Act”. Historical experience shows that such tax relief does not lead to high enough economic growth to offset the revenue losses in the long run. As a result, US national debt could spiral out of control in the medium term. Our simulations show that even slight increases in effective interest rates or moderate increases in the primary deficit lead to a disproportionately high increase in debt. The interaction between rising interest costs and growing expenditures in particular poses significant risks. Without countermeasures, the debt-to-GDP ratio could rise to between 150 and 170% over the next ten years. The actual tipping point for debt sustainability or when sentiment would drop can not be defined by specific figures. Historically, such tipping points often occur when investors start to reassess risks or when fundamental doubts about the stability of the institutional framework emerge. The development of US fiscal policy is also crucial from a European perspective. Growing doubts about US fiscal soundness would create tension in the global financial system which would also affect Europe.

The structural deficit has become entrenched

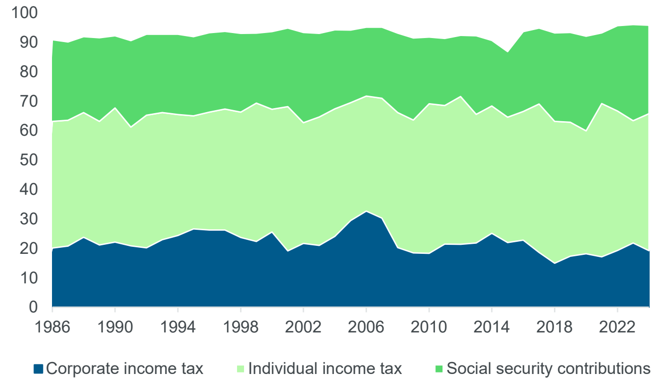
The US faces an increasingly tense fiscal situation: Public debt has been rising steadily for years, while budget deficits – the difference between expenditure and revenue – have become entrenched. Additional burdens are looming in the coming decades due to an aging population[1], rising social security expenditure and significantly higher interest payments on existing debt. President Trump’s plan to permanently extend the tax cuts of the Tax Cuts and Jobs Act (TCJA) appears risky in this context. The deficit is likely to expand further and confidence in the long-term fiscal stability of the US could be undermined.

A look at the historical development of the US revenue and expenditure structure provides key insights. The persistence of the budget deficit regardless of economic cycles – even during booms – highlights the structural nature of the fiscal imbalance. US government revenues primarily come from income taxes, social security contributions and corporate taxes. While income taxes remained the largest item at 46% in 2024, the share of corporate taxes fell over the last 30 years from about 23% in 1990 to 19% today (Figure 1) – partly due to tax reforms like the 2017 TCJA and global profit shifting by multinationals.

Meanwhile, social security contributions (Social Security and Medicare) have risen to nearly 30% in recent years.[2] These are deducted from wages along with income tax and fund retirement and healthcare for people over 65.

Figure 1: The three largest revenue sources in the US

In per cent, share of total revenue.

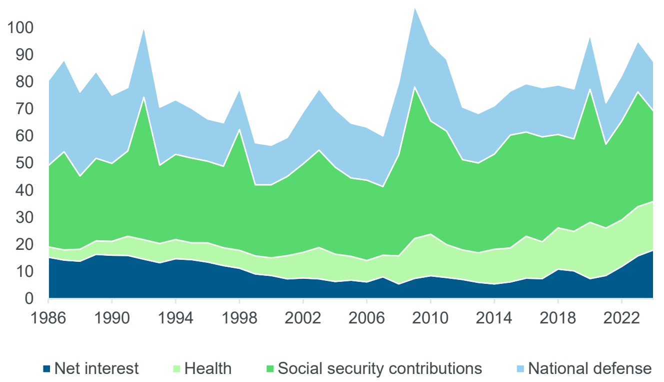


Source: Bureau of Economic Analysis, own computations.

On the expenditure side, healthcare spending in particular has gained significant weight, rising from under 5% of available revenues in 1990 to 18% in 2024 (see Figure 2). Interest payments on the growing debt also rose rapidly: In 2024, 18% of all government revenue went towards interest payments.[3]

Figure 2: The four largest expenditure items in the US

In per cent, share of total revenue.



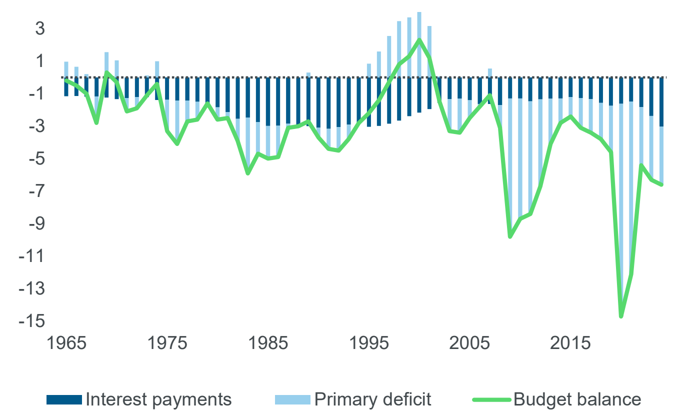
Source: Bureau of Economic Analysis, own computations.

Lessons from the past

There have been several attempts in recent decades to reduce the structural deficit. Notably, the consolidation phase in the 1990s under President Clinton led to a temporary budget surplus through tax increases, spending cuts and strong economic growth (Figure 3). "Pay-As-You-Go" rules were also introduced at the time, requiring new spending or tax cuts to be offset by savings or new revenue.[4] In contrast, reform proposals like those from the Simpson-Bowles Commission[5] in 2010 – which recommended a combination of tax increases and spending cuts – lacked broad political support. Instead, the Bush-era tax reforms and particularly the TCJA from Trump's first term (2017) led to renewed increases in deficits, without sustained efforts to counteract them.

Figure 3: US budget balance and interest payments since 1965

In percent of GDP.



Source: Congressional Budget Office.

Between 1975 and 1995, interest expenses increased sharply. Especially during the 1980s, high interest rates – in response to high inflation at the time – drove up debt servicing costs. Due to rising national debt, it became increasingly difficult to stabilise the interest burden. President Trump appears aware of this challenge as he repeatedly demands lower interest rates from the Federal Reserve. After the turn of the millennium, interest expenses declined significantly, even as debt levels rose. The main reason was the historically low interest rate environment following the Dotcom bust and the 2008 financial crisis. At the same time, nominal GDP increased, pushing down the interest-to-GDP ratio. It wasn't growth alone but primarily low interest rates that eased debt servicing burdens.[6]

Trump's first term ushered in increasingly expansionary fiscal policy. The TCJA lowered the corporate tax rate from 35 to 21%, reduced individual income tax rates across almost all income groups and modified several depreciation and deduction guidelines. The central economic argument for tax cuts – particularly on corporate profits and personal income – is that they boost economic activity and increase tax revenues in the medium term. However, a January 2025 analysis by the Committee for a Responsible Federal Budget (CRFB) concluded that the 2017 TCJA did not pay for itself. Although federal revenues from 2018 to 2024 exceeded original projections by USD 1.5 trillion, around two-thirds of that was a result of higher inflation. The remaining real revenue increase was concentrated almost exclusively in 2022 and driven by temporary effects such as post-pandemic recovery.[7] Federal Reserve data also shows that large, publicly listed companies significantly increased investment in the first year after TCJA but also used 60% of tax savings for stock buybacks, not productive investment.[8]

Tax cuts as a boost to potential growth?

Studies show that permanent tax cuts within certain bounds can moderately and temporarily boost potential growth. Potential growth – defined as sustainable capacity expansion without inflationary pressure – is primarily driven by technological innovation, labour force growth and capital accumulation. Tax cuts mostly improve utilisation of existing labour and capital but do not inherently generate new innovations or productivity gains. Past tax reforms only increased US potential growth by an average of 0.1 percentage points per year in the years that followed. In particular, the economic impact of higher government debt used to finance tax cuts dampened growth effects, as rising debt crowds out investment.[9]

Fiscal sustainability – a mammoth task

The tax cuts from President Trump's first term have set US fiscal policy on an unsustainable trajectory, leading to a continuously rising debt level. Increased spending on healthcare and social programmes, as well as rising interest payments due to high public debt, are key challenges. Possible solutions include increasing corporate and wealth taxes and implementing structural reforms to social programs – such as raising the retirement age or improving healthcare efficiency. Meanwhile, Trump has introduced a bill known as the "One Big Beautiful Bill Act" that would permanently extend tax cuts. This bill was approved in the House of Representatives on 22 May 2025 by a single-vote majority and passed the Senate on 1st of July after adjustments.[10] If the TCJA – or parts of it – are made permanent, the already limited fiscal leeway of the US government would be further constrained, with possible long-term implications for the stability and international confidence in the US economy.

The discussion around making the TCJA permanent is directly linked to past experiences. Current studies show that a permanent extension would incur massive fiscal costs. The US Tax Foundation estimates additional deficits of around USD 4.5 trillion by 2035, of which USD 3.6 trillion would stem from lost tax revenue and the rest from additional interest payments.[11] The Penn Wharton Budget Model forecasts a deficit increase of about USD 4 trillion for the period from 2025 to 2034.[12] Further simulations show that the investment incentives induced by tax relief are largely offset by the negative effects of rising public debt and higher interest rates. Overall, the model predicts only a modest increase in GDP of 0.2% by 2054 relative to current legislation. In short, the net effects on long-term growth remain small – especially if tax relief results in higher deficits and debt, which in turn drive up interest costs and hamper growth.

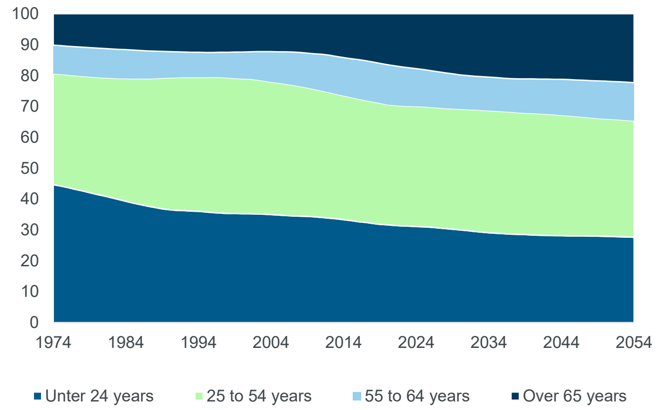
The US social security system: another challenge

The social security system is under increasing pressure. For around 40% of pensioners, it is the most important or even sole source of income.[13] Essentially, the social security system functions like a pay-as-you-go scheme – similar to Germany:

Current workers' contributions fund current pensions and benefits. With fewer contributors and more beneficiaries, the balance between income and expenditure is becoming increasingly unbalanced. Over the next two decades, about 78 million "Baby Boomers" will reach retirement age and begin drawing benefits. While in 1960 there were five contributors for every retiree, the ratio is now less than three to one – and is projected by the Congressional Budget Office (CBO) to fall to around two to one by 2035.[14]

Figure 4: Share of pensioners will continue to rise

In percent of total population.

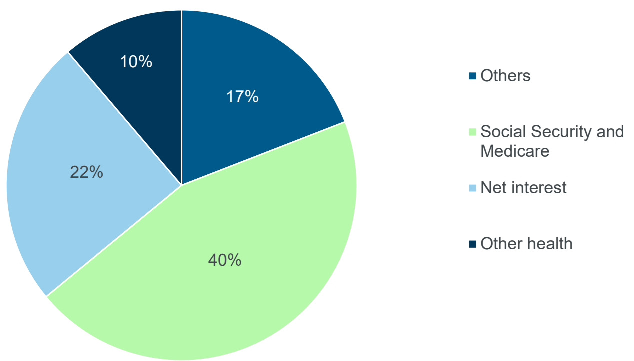


Source: Congressional Budget Office, own computations.

Experts warn that the Old-Age and Survivors Insurance (OASI) trust fund may be depleted by 2033. The OASI fund is a central part of the social security system, used for pension and dependant payments and financed by payroll contributions from employees and employers. Forecasts predict that, after 2033, it will only be possible to cover about 77% of planned benefits from ongoing revenues.[15] The gap will have to be filled from other sources, such as higher taxes, spending cuts, or increased public debt – further straining the federal budget.[16] Together with the pressured Medicare system, these programs will account for most of the future expenditure growth. Specifically, the *CBO* predicts that, between 2025 and 2035, about 83% of spending growth will stem from just three areas: Social Security, healthcare and net interest payments (Figure 5).[17]

Figure 5: Share of US nominal expenditure growth

In percent, predictions for 2025–2035.



Source: Committee for a Responsible Federal Budget.

Tariffs as fiscal rescue?

Since taking office, Donald Trump has pursued erratic trade policies. Import tariffs – such as the 10% base tariffs on all imports or duties on steel and aluminium – generate additional revenue. As Figure 6 shows, customs revenues tripled between January and May 2025 (up 202%) to USD 22.17 billion in May 2025. Seen annually, these higher tariffs could theoretically offset up to 50% of the revenue loss from extending the TCJA – assuming May 2025 levels are sustained.[18] However, this rough estimate does not account for the negative economic impacts of the tariffs on the US economy.[19] Permanently high or further increased import tariffs would also harm the US economy. Tariffs raise import prices, increase production costs and could ultimately reduce the competitiveness of US companies on global markets – especially if retaliatory tariffs from trade partners disrupt exports and supply chains.

Figure 6: US Customs revenue since 2015

In Million USD.

Source: Bloomberg.

A look into the future

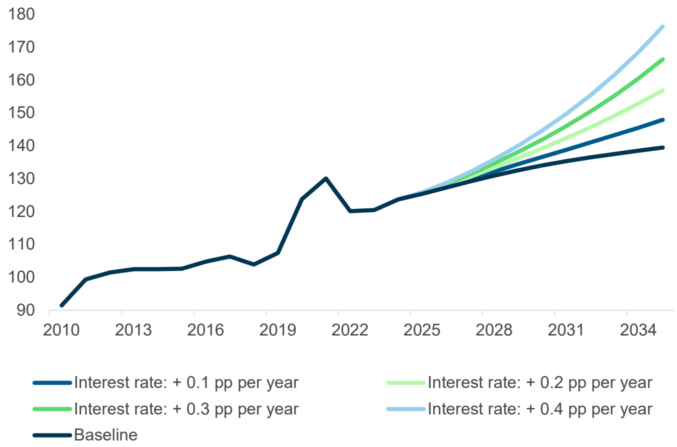
Based on historical data on US economic growth, debt ratios, primary deficits, interest costs and inflation, we simulated various scenarios for the future development of the US debt-to-GDP ratio. In the baseline scenario, we assume that the US economy grows at an average annual rate of 1.8%, as projected by the Congressional Budget Office, and that inflation averages 2.3% annually – the average from 2010–2024. The primary deficit is held constant at its 2024 level.

Even moderate increases in effective interest rates – by 0.2 to 0.3 percentage points per year – lead to a disproportionately high rise in the debt ratio as compared to the baseline scenario (see Figure 7). The reason: the absolute level of debt is already so high that even small changes in interest rates have major fiscal effects. Interest payments increasingly act as an independent burden that limits fiscal leeway, even if the primary balance is nearly in equilibrium.

Figure 8 illustrates the results of simulations showing a gradual annual increase in the primary deficit (i.e. the deficit before interest payments). The interest rate remains constant at 2024 levels. As long as the primary deficit increases only moderately, the debt ratio rises only slightly – mainly because nominal GDP growth and inflation partially offset the impact. But once primary expenditures increase significantly, the debt burden also rises noticeably in relation to economic output. This is particularly relevant given demographic spending pressures from Social Security and healthcare programmes like Medicare and Medicaid, where expenditure is set to grow in the coming years, placing more pressure on the primary deficit.

Figure 7: Interest rate changes and US debt

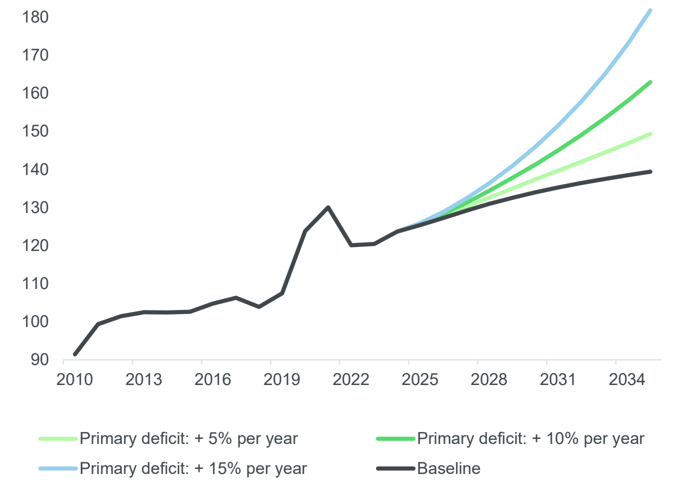
In percent of GDP.



Source: own simulations.

Figure 8: Primary deficit changes and US debt

In percent of GDP.



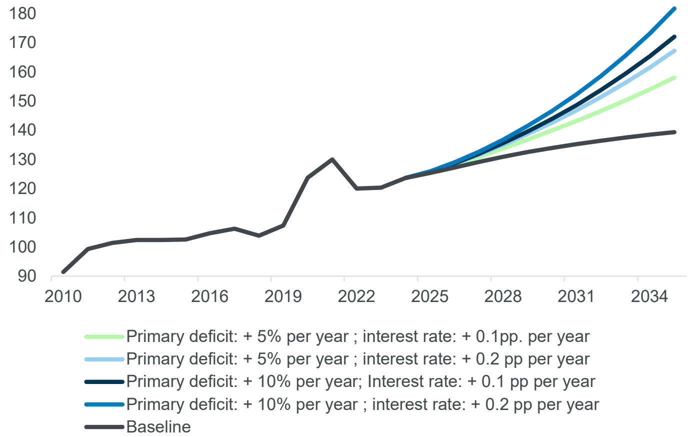
Source: own simulations.

A key fiscal challenge over the coming years lies in the interaction between rising interest costs and increasing expenditure. Higher interest payments directly reduce available fiscal scope and – especially when paired with structurally rising primary spending – can further enlarge the deficit. This feedback loop can accelerate debt dynamics, as Figure 9 shows.

Even slight increases in the interest rate, combined with rising primary deficits, can lead to significantly higher debt burdens. For example, a 10% annual increase in the deficit and a 0.1 percentage point rise in interest rates per year could push debt above 170% of GDP within 10 years. Conversely, a favourable interest rate environment and robust real economic growth are important levers for fiscal sustainability. They influence the debt ratio through both the numerator (interest burden) and denominator (GDP). Without a targeted consolidation strategy and/or stabilisation of interest rates, however, even optimistic assumptions are unlikely to reduce the debt ratio meaningfully.

Figure 9: Primary deficit changes, interest changes and US debt

In percent of GDP.



Source: own simulations.

When will financial markets get nervous?

Rising debt requires higher issuance of government bonds – and a receptive capital market. Historically, US government bonds have been considered the world's most important reserve and safe assets. But import tariffs, withdrawal from trade agreements and unilateral economic actions have shaken the perception of the US as a stable and predictable player within mere months. A warning sign appeared on 21 May 2025 during the auction of 20-year US government bonds worth USD 16 billion: demand fell short due to growing concerns about long-term fiscal stability. Yields on US bonds spiked across all maturities and the 30-year bond briefly hit 5.09%, near a 20-year high.[20] Another red flag came on 16 May 2025, when Moody's downgraded the US credit rating – following Fitch (2023) and Standard & Poor's (2011).[21]

Rising treasury yields in the US have an affect across the world. As a global benchmark, they influence financing costs, credit markets and capital allocation everywhere. Higher US yields could draw capital out of developing countries, risking financial instability there. The Federal Reserve also faces challenges. On the one hand, it may come under pressure to tighten monetary policy to counter inflation and rising interest rates. On the other hand, overly loose monetary policy to support government finances could stoke inflation and increase the risk of a "fiscal dominance" scenario – where fiscal constraints dictate monetary policy. Trump's strong demands for rate cuts make this more likely and could come to a head in May 2026 during the appointment of a new Fed chairperson. If markets perceive the Fed as yielding to political pressure and failing to address inflation risks, inflation expectations and long-term rates could rise sharply. A loss of confidence in the central bank could destabilise the economy and increase volatility in financial markets.

A possible tipping point?

The moment when investors lose confidence and a US debt crisis is triggered cannot be pinned to a specific debt level. Rather, the tipping point is psychological – arising from a mix of high debt, lack of consolidation strategies and dwindling trust in political decision-making. Critical factors include persistently high deficits, doubts about solvency or willingness to pay, or a perceived readiness to resort to monetary government financing. Historical examples – like the euro area debt crisis after 2010 or in emerging markets like Argentina – show that tipping points often emerge when investors start reassessing risks, even for previously "safe" borrowers.[22] The difficulty in anticipating a tipping point also lies in the dynamics of bond markets: decisions to sell may hinge less on fundamentals and more on perceptions of what other investors will do.

A loss of confidence would have serious consequences for the creditors of the US. Roughly 30% of US government bonds are held by foreign investors, while 70% are held domestically by investment funds, pension funds, insurers and banks. A sharp decline in bond prices would trigger significant book losses, pressure pension obligations, weaken bank balance sheets and put a strain on insurers.[23] The stability of the entire financial system could be threatened. The collapse of Silicon Valley Bank showed how quickly falling bond prices can destabilise banks.

Conclusion

The US fiscal outlook faces profound structural challenges that are likely to intensify in the coming years. The budget deficit has become a persistent structural issue that will remain or worsen without targeted countermeasures – such as tax increases or spending cuts. The combination of rising debt and high interest rates could further narrow fiscal room for manoeuvre. Proposals such as Donald Trump's "One Big Beautiful Bill" would further exacerbate the structural deficit. Even if such measures boost short-term growth, they risk pushing the US toward a "tipping point" for debt sustainability in the long run. If market confidence erodes, capital outflows, rising risk premiums and a dangerous debt-interest spiral could be triggered. The key question is whether US politics will have the courage to act responsibly – or whether short-term political interests will continue to dominate. Striking a balance between investment, confidence and fiscal soundness will be the central challenge of the years ahead.

---

1 The Population Reference Bureau (2024): "*Aging in the United States*", Fact Sheet: Aging in the United States | PRB, 09.01.2024.

2 US Treasury Fiscal Data (2025): *"How much revenue has the US government collected this year?",* Government Revenue | US Treasury Fiscal Data.

3 US Treasury Fiscal Data (2025): "*How much has the US government spent this year*?", Federal Spending | US Treasury Fiscal Data.

4 The Heritage Foundation (1997): "*Making Pay-Go Pay Off*", Making Pay-Go Pay Off | The Heritage Foundation, 09.06.1997.

5 Center on Budget and and Policy Priorities (2012): What Was Actually in Bowles-Simpson — And How Can We Compare it With Other Plans? | Center on Budget and Policy Priorities, 02.10.2012.

6 Peterson Institute for International Economics (2020): "*US debt has increased, but burden of servicing it has fallen*", US debt has increased, but burden of servicing it has fallen | PIIE, 16.12.2020.

7 Committee for a Responsible Federal Budget (2025): "*Has TCJA Paid For Itself?*", Has TCJA Paid For Itself?-2025-01-22, 22.05.2025.

8 Forbes (2019): "*Why The Tax Cuts And Jobs Act (TCJA) Led To Buybacks Rather Than Investment*", Why The Tax Cuts And Jobs Act (TCJA) Led To Buybacks Rather Than Investment, 21.01.2019.

9 Committee for a Responsible Federal Budget (2017): "*Can Tax Reform Generate 0.4 % Additional Growth?"* 4 point growth paper final_0.pdf, 27.11.2017.

10 See current developments: H.R.1 - 119th Congress (2025-2026): One Big Beautiful Bill Act | Congress.gov | Library of Congress.

11 Tax Foundation (2025): "*Making the Tax Cuts and Jobs Act Permanent: Economic, Revenue, and Distributional Effects*", Making the Tax Cuts and Jobs Act (TCJA) Permanent: Analysis, 26.02.2025.

12 University of Pennsylvania (2024): "*The Budgetary and Economic Effects of permanently extending the 2017 Tax Cuts and Jobs Acts' expiring provisions*", The Budgetary and Economic Effects of permanently extending the 2017 Tax Cuts and Jobs Acts' expiring provisions — Penn Wharton Budget Model, 22.05.2024.

13 National Institute on Retirement Security (2020): "*40 % of Older Americans Rely Solely on Social Security for Retirement Income*", New Report: 40% of Older Americans Rely Solely on Social Security for Retirement Income - National Institute on Retirement Security, 13.01.2020.

14 Congressional Budget Office (2025): "*The Demographic Outlook: 2024 to 2054*", The Demographic Outlook: 2024 to 2054 | Congressional Budget Office, 18.01.2024.

15 Social Security Administration (2025): "*Status of the Social Security and Medicare Programs*", Trustees Report Summary.

16 Peter G. Peterson Foundation (2025): "*Long-Term Budget Outlook Leaves No Room for Costly Legislation*", Long-Term Budget Outlook Leaves No Room for Costly Legislation, 27.03.2025.

17 Committee for a Responsible Federal Budget (2025): More than 4/5 of Spending Growth Will Come from Social Security, Health, & Interest-2025-01-28, 28.01.2025.

18 Projected from the customs revenues in May 2025, there would be annual additional revenues of USD 187 billion compared to the customs revenues of USD 79 billion from 2024. In contrast, the estimated tax losses from an extension of the TCJA average USD 360 billion per year. Thus, the additional customs revenues could compensate for up to 50% of the revenue losses from an extension of the TCJA.

19 US Tax Foundation (2025): "*Current Trump Tariffs Threaten to Offset Benefits of Promised Tax Cuts*", Trump Tariffs Threaten to Offset Trump Tax Cuts: Analysis.

20 Barron's (2025): "*20-Year Treasury Auction Goes Badly, Yields Spike as Bonds Sell Off*", 20-Year Treasury Auction Goes Badly, Yields Spike as Bonds Sell Off - Barron's, 21.05.2025.

21 Moody's (2025) "*Moody's Ratings downgrades United States ratings to Aa1 from Aaa; changes outlook to stable*", 2025 United States Sovereign Rating Action - Moody's, 16.05.2025.

22 Deutsche Bundesbank (2012): Finanzsystemstabilität und nachhaltiges Wachstum | Deutsche Bundesbank, *("Financial system stability and sustainable growth", German only)*, 28.11.2012.

23 Peter G. Peterson Foundation (2025): "*The Federal Government Has Borrowed Trillions. Who Owns All that Debt?*", The Federal Government Has Borrowed Trillions. Who Owns All that Debt?, 13.05.2025.