

Economics

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Federal fiscal facts and fictions: The US deficit outlook and implications

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There's a saying that "everybody talks about the weather, but nobody does anything about it", but the same could be said about the US budget deficit, at least in Washington. Outside the nation's capital, the American voting public doesn't really think a lot about budget deficits, and that's largely why their governments don't do anything about them. A look at the facts and fictions surrounding the federal deficit suggests that indifference is likely to continue for a while longer, so we need to consider the implications for financial markets.

Not a crisis...yet

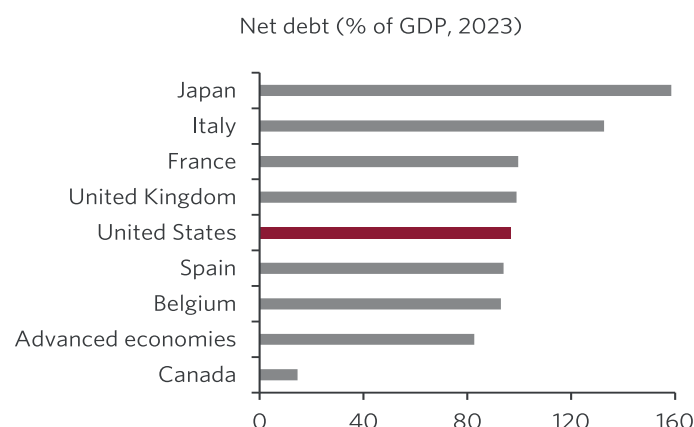
The 2023 deficit of \$1.7 trillion exceeded 6% of GDP, and it would have hit \$2 trillion if not for some quirks in payment timing and the how changes to student loans were accounted for. We might see a small taste of fiscal discipline as part of a deal to keep the government open. But Washington can and will mostly ignore the fiscal mess in the here and now, because the reality is that the US is not currently in a debt or deficit crisis.

Aggregating all levels of government for better comparability with countries that aren't federal states, America's net debt (and gross debt) is on the high side relative to other advanced economies (Chart 1). But there are others that look worse, and their economies are not necessarily faring badly, nor are markets shunning their bonds.

That's not to say that high levels of government debt are never problematic. Absent the ultra low interest rate environment of the last cycle, chronic deficits would see interest payments climbing relative to either revenues or GDP, to the point where higher taxes, and their burden on economic growth, are needed to merely cover the interest costs. On that score, while the combination of higher interest rates and larger debts has pushed up interest payments, as a share of revenue, they are still below what the US economy managed to endure during the period in which much higher bond yields prevailed in the 1980s and 90s (Chart 2).

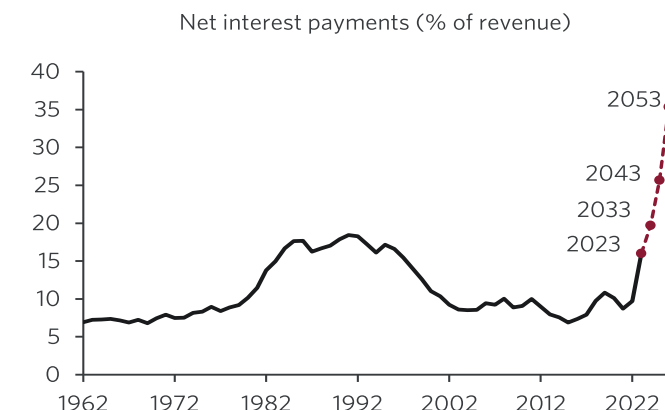
But if that means there isn't a crisis now, there's certainly the risk of one well out in the future. The Congressional Budget

Chart 1: US net debt: not great, not the worst



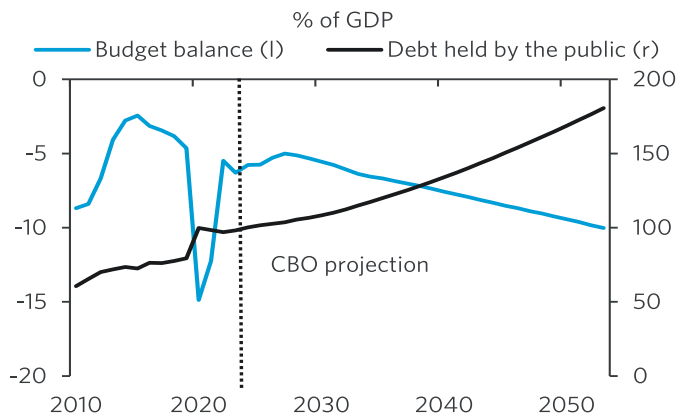
Source: IMF, CIBC (Note: Canada's gross debt is 106% of GDP versus US at 123%, advanced econ 112%)

Chart 2: Interest payments contained... but not for long



Source: CBO, CIBC

Chart 3: Deeper deficits, higher debt levels on the horizon



Source: CBO, CIBC

Office projects that under current tax and spending policies, debt held by the public will nearly double from current levels (Chart 3). At that point, interest on the debt, at nearly 7% of GDP, will be eating up more than a third of government revenues. Sometime between then and now, governments will have to arrest that trend. But just not yet it seems.

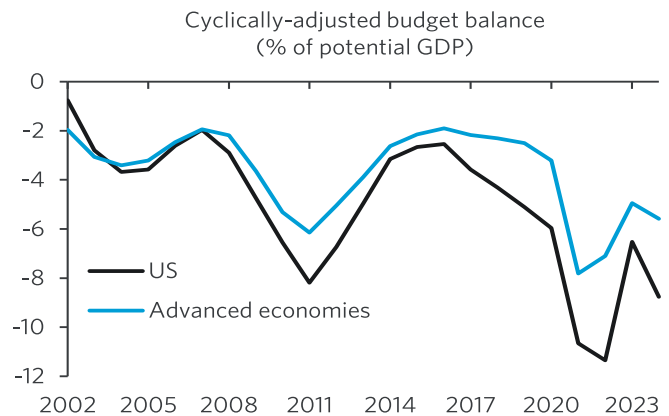
Prior to this year, the US had been drawing comfort that on any one lump of new debt that it added, the financing costs of rolling that debt and its accumulated interest would grow slower than GDP, because the economy was expanding at a faster rate than the average real interest rate on the debt. While we expect rates to ease in the next two years, the average yield on new debt could end up settling at only a bit below 3½% over the medium term, or roughly in line with nominal trend growth.

How we got here

Deficits in the range of 6% of GDP that are expected to prevail in the next couple of years are nothing new. We've seen worse. But there is something unusual about where we stand now: these are large shortfalls for a period in which the economy sits near or perhaps even through full employment. As a result, the cyclically-adjusted deficit, while not as wide as it was during the period of massive stimulus at the height of the pandemic, is much wider than it was, for example, back in 2018, when the economy was similarly a bit overheated and the Fed was engaged in the tightening cycle. The US also compares unfavourably on that score to the average of all advanced economies (Chart 4).

The common wisdom is that Washington got to where we are by overspending, and maintaining stimulus from discretionary spending in a period in which the economy no longer needed it. That impression has been reinforced by a few big ticket budget measures passed in recent years, including the IRA, directed at subsidies for climate initiatives, the CHIPS Act, and other infrastructure funds.

Chart 4: US deficit unusually large for economy at full employment

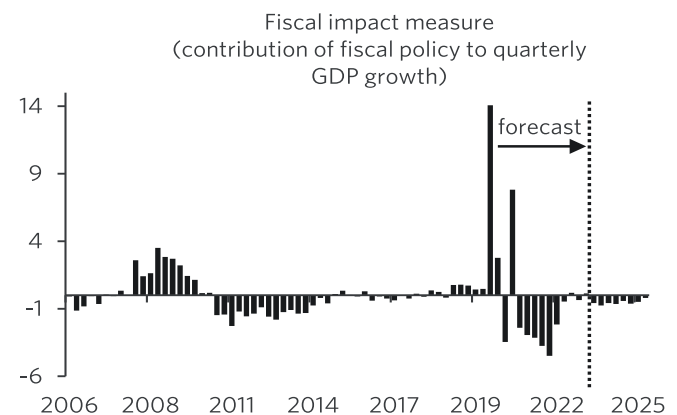


Source: IMF, CIBC

But while large, these bills stretch out over many years. Moreover, other spending measures that had been in place during the pandemic have been winding down or were eliminated. The Hutchins Center estimates that when you add it all up, in terms of the changes in spending relative to nominal GDP and tax rate measures, fiscal policy is actually a small drag on growth. That said, it's much less of a drag than what was delivered in the prior cycle, as Obama's big stimulus budgets gave way to restraint at the federal and state levels (Chart 5).

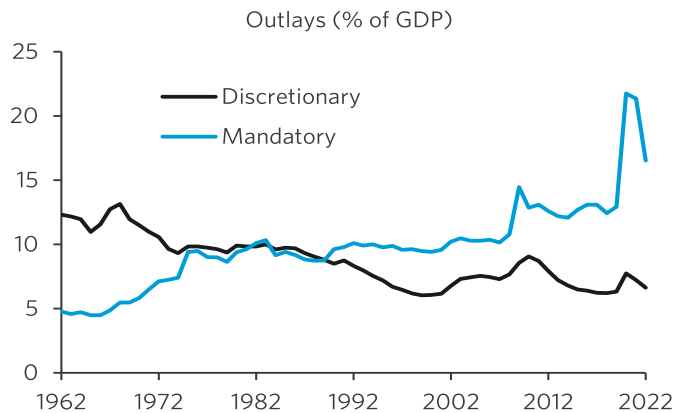
One way to dissect how we got here is to look back to the good old days when the forecast path for federal debt looked much less problematic, in 2007. As a recent study from the Aspen Institute pointed out, just ahead of the recession tied to the global financial crisis, the CBO was projecting that the economic and policy outlook would actually see federal debt/GDP in a steady decline from a bit under 40% to less than half that ratio by 2020, and then only retaining the 40% mark after 2045. Instead, the debt/GDP ratio essentially doubled by 2020, and is on a path to keep climbing. What changed?

Chart 5: Fiscal stimulus to continue to be a modest drag on activity



Source: Hutchins Center

Chart 6: Mandatory spending items behind higher outlays as population ages

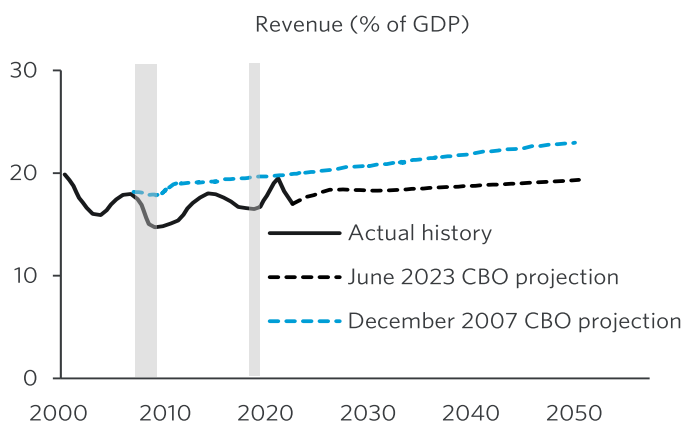


Source: CBO, CIBC

Program spending had two huge spikes tied to recessions not built into the CBO forecast, but isn't today appreciably higher as a share of GDP than what was expected in 2007. The growth in spending as a share of GDP, tied to an aging population's impact on health and retirement costs, was well anticipated by the CBO back in 2007. Indeed, a breakdown of spending into discretionary and mandatory programs, with the latter covering items like social security and health care, shows that prior to the pandemic, all of the growth in spending as a share of GDP was driven by mandatory items (Chart 6).

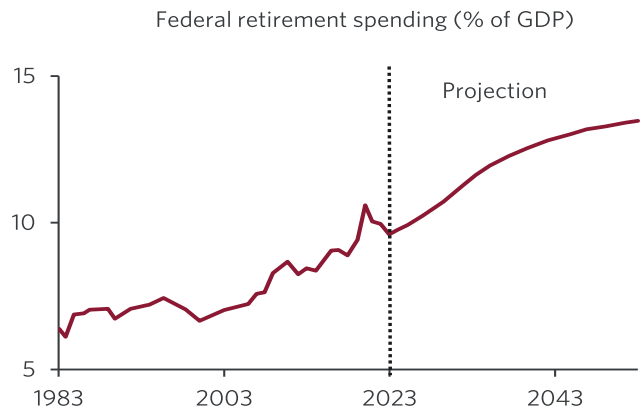
Instead, the sustained negative surprise was on the revenue side. Sure, recessions knocked revenues for a temporary loop, but wouldn't have permanently altered the government's slice of the economic pie. Instead, it was two major rounds of tax cuts since the turn of the millennium that have kept revenues weaker as a share of GDP than what was built into projections in 2007 (Chart 7). This isn't to say that such tax cuts have no value for growth or economic health, only that they were the

Chart 7: Revenue growth has lagged 2007 projections due to tax cuts



Source: Aspen Institute, CIBC

Chart 8: Aging population will require increasing federal support



Source: Brookings, CIBC

key policy change behind the course correction for US debt growth.

It will get worse before it gets better

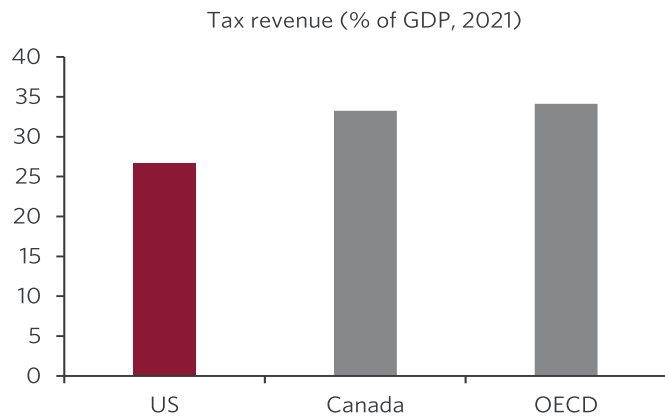
Where spending does appear to be an issue is its projected path under current policies over the medium term. But that's overwhelmingly a story tied to demographics and so called "mandatory" program spending, rather than discretionary expenditures. The former includes Medicare and Social Security, two major spending envelopes that, barring changes in their terms, tend to grow in cost as the population ages. Add in tax benefits for retirees, and the fact that Americans are getting older will be a major barrier to running smaller deficits as a share of GDP (Chart 8).

The other key item is interest on the debt. In fact, nearly all of the CBO's projected increase in deficits as a share of GDP from today to 2053 can be attributed to that one item. The growth cited above in mandatory spending as a share of GDP will be nearly all offset by gains in revenues or projected declines in discretionary spending as a share of GDP, although that assumes that some non-permanent tax cuts are allowed to expire.

Congress and the White House have the means to arrest this trend, but at least in the next few years, that seems unlikely. For now, we're in a stalemate, with Republicans controlling the House, and the Democrats holding the Senate and the White House. A core of the Democrats sees the entitlement programs that account for most of the future growth in spending as untouchable, and aren't willing to advocate tax hikes that extend beyond the very wealthy.

But even if we had a GOP sweep in November 2024, the Republican party would have to heal its own divisions. Senate Republicans, for example, favour more defense spending than their House peers. A core in the House GOP, along with Nikki Haley, have spoke openly about cuts to major entitlements like Social Security, but other Republican lawmakers and

Chart 9: Room to raise taxes in the US



Source: OECD, CIBC

presidential candidates are less inclined to do so. And many in the GOP aim to divert program savings to further tax cuts rather than smaller deficits.

No immediate pressure to act

Don't blame the politicians, because as they say, voters get the governments we deserve. Stern action on the deficit isn't forthcoming because the most visible impacts of deficits for the average voter, in the form of their contribution to either inflation or high interest rates, are likely to soften in the coming year as the Fed begins an easing cycle.

While greater borrowing needs, all else equal, elevate yields for both governments and private borrowers, there are several safety valves that will open to relieve that pressure and allow for a bond market rally, even if rates across the curve don't end up quite as tame as would be the case if fiscal policy was tightened. Household savings rates are likely to rise as consumers exhaust pandemic era savings, and are tempted by higher yields. That will help sop up more supply. The Treasury was able to fully reverse what had been a huge shock to long rates after announcing greater funding needs by subsequently shifting that funding to the short end of the curve.

The Fed, for its part, used that initial sell-off in the long end as a reason to put off another hike, and could ease more in 2024 if needed to offset sticky long rates. It's also projected to wind up its QT program by the end of this fiscal year, eliminating the need for the additional public market financings that are supplanting the Fed's Treasury holdings. As a result, the pressure we've felt in the bond market from increases in net supply will fade once QT has been completed, even if deficits remain near current levels. In fact, the US could return to pre-pandemic net supply levels if it got the post-QT deficit down to 3% of GDP. Well down the road, it will be the interest squeeze on programs, not bond market vigilantes, that pressures Washington into action on deficits.

Relief, eventually

The economist Herbert Stein reminded us that "if something can't go on forever, it won't". That's the best reason to expect that before the US reaches much higher debt service burdens, governments will act, as the threat that taxes will increasingly go to interest, and squeeze out program spending, is what brought liberals like Bill Clinton on board with deficit reduction. North of the border, it was also the leader of a left-leaning Liberal Party, that engineered a major assault on Canada's deficit when interest burdens reached unsustainable heights. So, we would expect politics to swing on this issue in the US beyond 2030, and before true crisis hits.

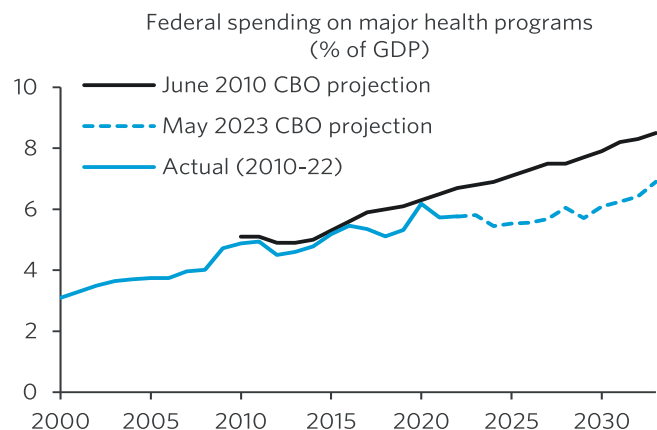
Relying on any one item — cutting non-defense discretionary spending, reducing social security payments, raising personal and corporate taxes — would end up being either too unpopular, or too economically damaging. Other possibilities, including new carbon taxes or a major new federal sales tax for example, don't appear to be at all on the radar screen, however meritorious some economists might find them.

But one bite a time, there's still room to make a difference. The objective won't be to run large surpluses and bring the debt/GDP crashing down, but simply to move towards a primary balance, in which the deficit was equal to interest payments. If at that point interest rates and nominal growth are closely in line, running a primary balance would be sufficient to stabilize the debt/GDP ratio rather than having it continue to escalate.

On the revenue side, there's room for the US to reverse some of the past tax reductions without making the economy unduly uncompetitive. OECD data shows that the overall US tax take is currently at the lower end of comparable economies (Chart 9).

Spending on entitlements might not be as untouchable as that's made out to be, because there are steps that could be taken to pare spending growth without reducing services. As an example, the US has seen some pleasant surprises in containing health care costs in recent years, so it's possible that our actual

Chart 10: Spending on health programs has been lower than thought, but projected to increase



Source: CBO, CIBC

mileage on health care will differ, and entail a slower spending climb. Federal health care spending flattened out on a per-beneficiary basis and therefore grew only slowly as a share of GDP after 2010 (Chart 10), with the exception of a spike during the first year of the pandemic. That was in contrast to the prior trend showing growth, and the assumption baked into current forecasts for increases in costs per beneficiary ahead.

Changes in how some services are delivered, including long-term care, savings as some drugs came off patent protection, and tendency for new innovations to be cost-saving rather than additive to costs, have been factors in this pleasant trend. New drugs that reduce obesity, contain heart disease and better control diabetes might leave us on that flatter trend. Of late, US life expectancies have declined (partly tied to COVID-19), which in a less happy way could also pare estimates for future spending on the elderly.

On social security, it could be made more affordable over the medium term by stemming the pace at which the number of recipients is rising relative to those still working and paying taxes. The US has a much lower rate of immigration than some other countries, and if reforms tilted new arrivals to younger workers with needed skills, that would push off some of the demographic challenges. Canada has raised the share of women with children in the workforce through subsidized childcare and a tax system more favourable to households with a second income earner.

None of these measures would be instant cures, but the doomsday projections for the US fiscal stance entail long term paths. Modest increases in revenue growth, or decreases in the pace for expenditure gains, can and will add up.

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