Weekly Economic Commentary

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Blasé on the Budget

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Highlights

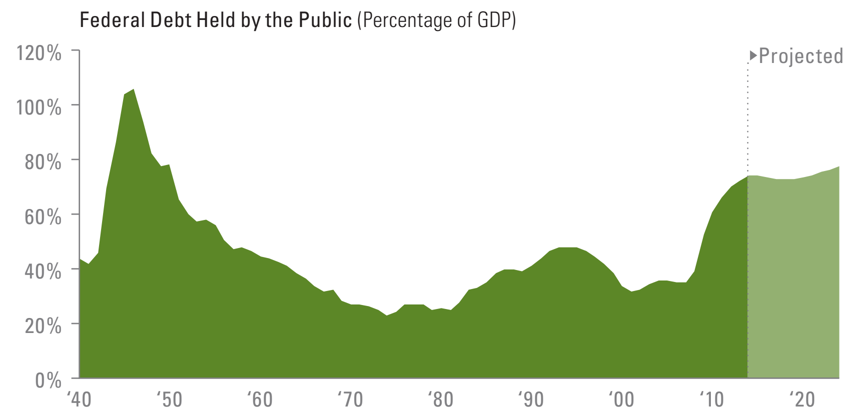
The nation's fiscal situation has improved dramatically in the past five years due to overall economic improvement and a combination of higher tax rates and modest spending increases.

However, structural and demographic problems that will drive the deficit over the next several decades remain in place.

If policymakers continue to ignore critical warning signs, the near-term improvement in the budget picture is unlikely to last.

The U.S. Treasury will report the federal budget figures for fiscal year (FY) 2014, which ended on September 30, 2014, as soon as this week (October 6–10, 2014). According to a recent report by the nonpartisan Congressional Budget Office (CBO), the United States will likely run a $506 billion deficit in FY 2014, a $170 billion improvement from the $676 billion deficit racked up in FY 2013. As a percent of nominal gross domestic product (GDP), the deficit in FY 2014 is expected to be 2.9%, down from 4.1% in FY 2013, leaving the public debt-to-GDP ratio—a key metric for global financial markets to assess the creditworthiness of a country—at 74% [Figure 1].

1 The Debt-to-GDP Ratio Has Risen Despite Improvement on the Deficit, and Remains Stable for Now



Source: LPL Financial Research, Congressional Budget Office 10/03/14

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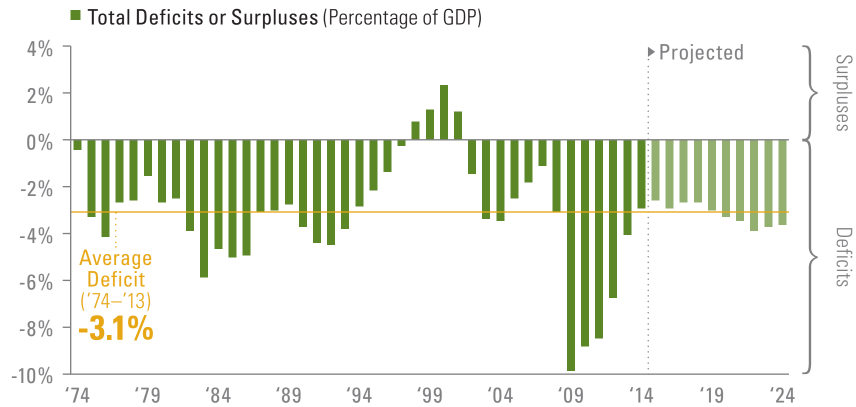
As recently as 2009, the federal deficit clocked in at $1.4 trillion, or nearly 10% of GDP, so the nation's fiscal situation has improved dramatically in the past five years thanks to an improved economy and a combination of higher tax rates and limited spending increases driven by Congressional actions like the sequester and the fiscal cliff [Figure 2]. Some "one-time" items (e.g., Troubled Asset Relief Program [TARP], accounting related to Fannie Mae and Freddie Mac) also helped to reduce the deficit. But because the deficit—and the borrowing to finance the deficit—have increased faster than the overall economy, the debt-to-GDP ratio has deteriorated from around 50% in 2009 to 74% today.

Federal Debt

The federal debt is simply the federal deficit accumulated over the years. When the deficit increases in a given year because the federal government spends more than it takes in, the debt increases. There are several measures of federal debt, the broadest being total public debt outstanding, which was $17.7 trillion at the end of August 2014. Of that, $12.7 trillion was marketable and held by the public (and half of that held by foreigners), while $5 trillion was owned by entities within the federal government.

The debt-to-GDP ratio is calculated by dividing the debt (total, held by public, etc.) by nominal GDP (see *Weekly Economic Commentary*, "The ABCs of GDP," May 6, 2013), which stands at $17.3 trillion. So the United States' debt-to-GDP ratio measured by total debt outstanding ($17.7 trillion) divided by nominal GDP ($17.3 trillion) is 102%. However, most market participants exclude the federal debt owed to other federal government entities and calculate the debt-to-GDP ratio as debt owned by the public ($12.7 trillion) divided by nominal GDP ($17.3 trillion) for a debt-to-GDP ratio of just over 73%.

2 The Federal Deficit Has Improved Rapidly as the Economy Has Improved; but by the End of the Decade, Demographics Are Likely to Drive the Deficit Higher Again



Source: LPL Financial Research, Congressional Budget Office 10/03/14

Deficit Deterioration

Looking ahead, the CBO expects (and we concur) that the deficit will shrink, and by late this decade will decline to around 2.7% of GDP, which would be the lowest deficit-to-GDP reading since 2007, prior to the onset of the Great Recession. At that point, the debt-to-GDP ratio will be little changed from the FY 2014 reading of around 74%. But, beginning in the last few years of this decade and into the first half of the 2020s, the CBO expects the deficit will begin to widen again. And by 2024, the expected deficit will hit $960 billion, or 3.6% of GDP, pushing the all-important public debt-to-GDP ratio to over 77% of GDP. The improvement in the deficit in the next several years is expected to be driven by an improving economy and the spending constraints put in place by Congress over the past several years.

Written Warnings

Some warning signs exist in the otherwise positive budget picture that has developed over the past five fiscal years. If policymakers continue to ignore these warning signs, the near-term improvement in the budget picture is not likely to last, as noted above. In FY 2014 to date (October 2013 through August 2014), federal spending on mandatory programs (payments set by formulas written into the law), like Social Security, Medicare, and Medicaid, is running above the pace of nominal GDP growth (4.2% in the four quarters ending in Q2 2014). Federal spending on Social Security benefits is up 4.6%, whereas spending on Medicare and Medicaid are up a combined 4.2%, equal to the pace of nominal GDP growth.

Most of the deficit deterioration in the latter half of this decade and the first half of the next decade will occur as a result of deterioration in the structural deficit, i.e., spending on mandatory programs like Social Security, Medicare, and Medicaid far outstripping the pace of GDP growth, mainly due to an aging population. The CBO projects that tax receipts targeted for use by those programs will only grow at the same pace as the overall economy over the

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next 10 years or so. Thus, the risk is that Congress and the general public will be distracted by the rapidly improving near-term budget outlook and will not address the longer-term structural budget problem quickly enough to head off a worsening long-term budget deficit.

The good news on the budget is that the deficit, debt, and the pace of federal spending are not on the market's radar screen right now. The stable debt-to-GDP ratio over the remainder of the decade (forecast by the CBO) also provides a window for action to be taken by Congress to fix the underlying structural problems in the budget, which have been masked—and indeed overwhelmed—by the improving economy and the near-term spending constraints imposed by Congress on the nondefense discretionary portion of the budget. Any Congressional action to address these underlying issues in the budget are unlikely until after the 2016 presidential elections, but recent history suggests that Congress likely won't act until a crisis is already underway. The biggest risk on the federal debt is that the recent improvement in the deficit (and relative stability in the debt-to-GDP ratio) allows complacency to set in among policymakers in Washington.

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