

ECONOMIC VIEWPOINT



The U.S. Budget Situation: Much Worse despite Economic Growth

Decisions by the Trump Administration and Congress Come with a Big Price Tag

After improving for a few years early in the decade, the imbalance in the U.S. federal government's finances has started to worsen again. The deficit reached US\$665B at the end of fiscal 2017, and the situation should keep eroding in the coming years, according to the Congressional Budget Office's (CBO) latest projections. At this point in the economic cycle, growth should put a balanced budget within reach, but Washington's latest decisions will instead make deficits and the debt balloon in the coming years. The situation could put some upside pressure on interest rates, as well as become a problematic issue if the economy suffers another setback.

The Situation Now

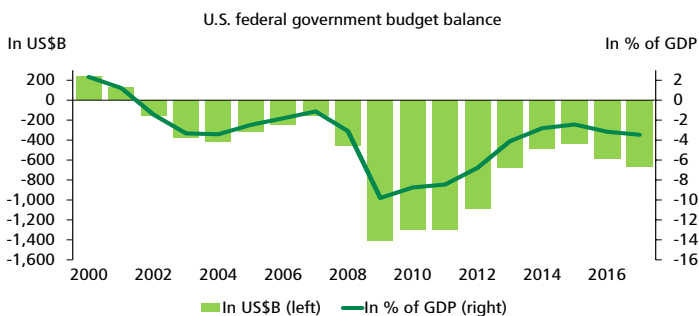
In fiscal 2009,¹ the economic and financial crisis drove the federal budget deficit to a peak of US\$1,412.7B (9.8% of GDP). The situation then improved thanks to the better economic situation, some tax increases, and measures to restrict federal spending. In this cycle, the smallest deficit, US\$438.5B or 2.4% of GDP, came in 2015. In the next two fiscal years, however, public finances deteriorated again, with deficits of US\$584.7B (3.2% of GDP) in 2016, and US\$665.4B (3.5% of GDP) in 2017 (graph 1).

Among other things, the bigger deficits were triggered by weak revenue from corporate tax and an increase in spending on social programs.

Expenditures

Social programs account for a very large proportion of the U.S. federal government's spending. The main programs are, by far, Social Security (old age pensions), Medicare (health insurance for the elderly) and Medicaid (health insurance for people with very low incomes). Together, the three programs cost US\$2,016B in 2017, or 50.6% of federal spending (graph 2). The other non-discretionary expenditures (i.e. expenditures that are not dependent on an annual budget) and debt service

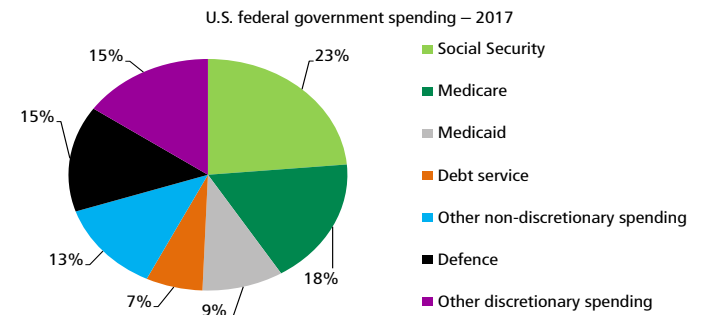
GRAPH 1
The budget deficit has begun to erode again in recent years



Sources: Congressional Budget Office and Desjardins, Economic Studies

¹ The U.S. federal government's fiscal year begins on October 1st and ends on September 30. Fiscal 2018 therefore started in October 2017, and runs until September 2018.

GRAPH 2
Social programs and defence have a very large share of federal spending



Sources: Congressional Budget Office and Desjardins, Economic Studies

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added up to US\$766B. In addition, there are the discretionary expenditures that must be reviewed each year, either through a congressional budget bill, or through the appropriations process (vote on appropriations by department). The discretionary expenditures cost US\$1,200B in 2017, with US\$590B going to defence and US\$610B going toward all other federal government expenditures. Note that, in recent years, growth by discretionary spending was much slower than growth by spending on social programs and even showed contractions (graph 3). The limits imposed after the 2011 debt ceiling crisis and the numerous confrontations between the Obama administration and Congress's Republican majority are responsible for the small growth.

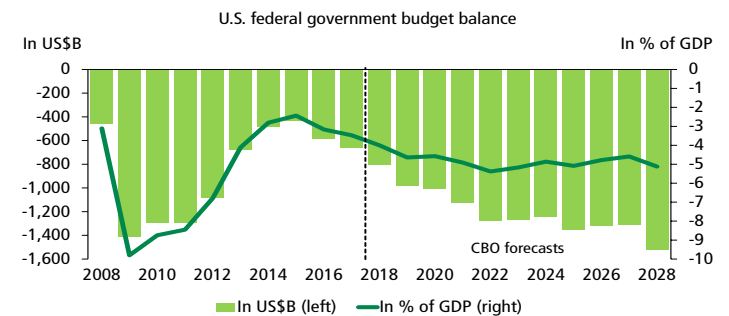
from the tax on corporate profits are much smaller, at US\$297B last year, representing just 8.9% of revenue. The surpluses from the Federal Reserve (Fed) are one of the other revenue sources, representing US\$81B in 2017, down from the peak of US\$155.6B in 2016.

The CBO's New Projections

The CBO, a non-partisan congressional agency whose role is to assess the budget outlook and costs of various bills,² recently released its [forecasts for the 2018–2028 horizon](#). It is quickly clear that the recent trend of eroding public finances will persist in the coming years. The federal government's budget balance will go from -US\$665.4B in 2017 to -US\$804B in fiscal 2018, which will end on September 30. The deficit will keep ballooning in the next few years, and should go above US\$1,000B as of fiscal 2020.

The deficits also represent increases in terms of the proportion of GDP (graph 5). From 3.5% in 2017, the percentage goes to 4.0% as of 2018, then keeps rising toward 4.5% in 2019. It is forecast to peak at 5.4% in 2022. It then remains relatively stable at around 5% after that.

**GRAPH 5
The deficits will increase substantially in the coming years**

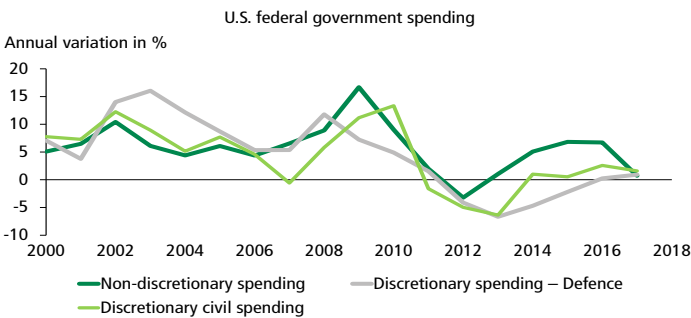


CBO: Congressional Budget Office
Sources: CBO and Desjardins, Economic Studies

Note that, in the CBO's projections, expenditures as a proportion of GDP go up substantially, rising from 20.8% in 2017 to 23.6% in 2028. This increase is solely due to the fact that expenditures for Social Security and old age pensions are expected to increase due to population ageing. Together, these two expenditure items will go from 8.6% of GDP in 2017 to 11.1% in 2028. As a proportion of GDP and according to the CBO, discretionary expenditures will decline from 6.3% in 2017 to 5.4% in 2028, but will rise to 6.4% in 2018 and 2019. For the period as a whole, for discretionary civil spending, the 3.1% average will

² For more information on parliamentary budget analysis offices like the CBO, see: [A primer on parliamentary budget offices](#), Desjardins, Economic Studies, *Economic Viewpoint*, March 3rd, 2016, 4 p.

**GRAPH 3
Since 2012, the increase in spending mainly comes from non-discretionary expenditures associated with social programs**

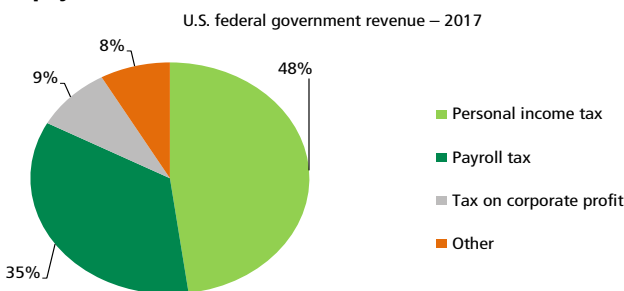


Sources: Datastream and Desjardins, Economic Studies

Revenues

The U.S. federal government's biggest revenue stream comes from personal income tax, which totalled US\$1,587B in 2017. It is followed by payroll tax, which primarily goes to social programs and unemployment insurance. Employees and employers pay equal shares of the payroll tax, which totalled US\$1,162B in 2017. These two tax sources accounted for 82.9% of the government's revenue in 2017 (graph 4). The amounts derived

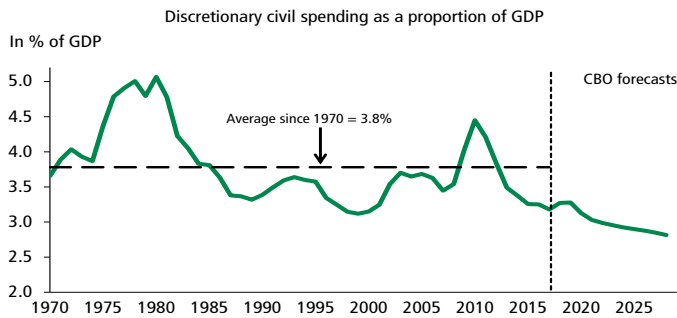
**GRAPH 4
Government revenue comes mainly from personal income tax and payroll tax**



Sources: Congressional Budget Office and Desjardins, Economic Studies

be much lower than the historic average of 3.8% recorded between 1970 and 2017 (graph 6).

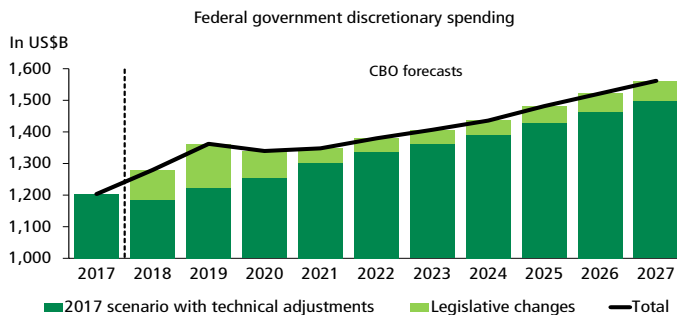
GRAPH 6
Non-social program civil spending is declining



CBO: Congressional Budget Office
Sources: CBO and Desjardins, Economic Studies

The increase in discretionary expenditures in 2018 and 2019, with respective annual growth of 6.6% and 6.4%, mainly comes from the 2018 budget agreement (Bipartisan Budget Act of 2018) and the recent bill on the government’s annual financing (Consolidated Appropriations Act), the fruit of negotiations between the White House and Republican and Democratic leaders of Congress. Without these legislative changes, the spending increases would be much smaller in the near term (graph 7).

GRAPH 7
The recent budget agreements will make spending jump



CBO: Congressional Budget Office
Sources: CBO and Desjardins, Economic Studies

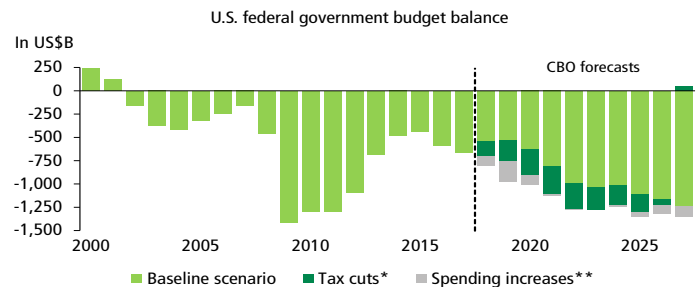
The other main contribution to the swelling deficit in both the short and long term is the tax cut bill that passed at the end of last year. Between 2017 and 2018, federal revenue from tax (personal income tax, payroll tax, and corporate tax) goes up a little in current dollars, rising \$13.5B or 0.4%. That is small potatoes in relation to the 5.2% growth by nominal GDP the CBO is forecasting for 2018. As a proportion of GDP, the tax

revenue drops from 15.9% in 2017 to 15.2% in 2018. The ratio will slowly close in on 16% in subsequent years.

Without taking the CBO’s estimated positive macroeconomic effects into consideration, the tax cuts will have a budget cost of US\$197B for fiscal 2018 (the impact only covers nine months) and US\$289B in 2019. Including the positive impact of the tax relief for households and businesses on economic growth, the budget cost drops to US\$164B in 2018 and US\$228B in 2019. The maximum cost comes in 2021, at US\$292B. Over 10 years, the total cost is US\$2,314B without the macroeconomic effect, and US\$1,854B when the positive impact predicted by the CBO is included.

Note that the combination of higher expenditures and tax cuts will play a major role in the deterioration of public finances. These measures will therefore erode a budget situation that was already heading in the wrong direction (graph 8).

GRAPH 8
The tax cuts and budget agreements will make the deficits worse



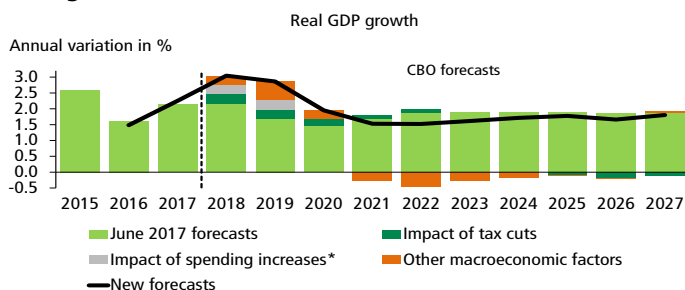
CBO: Congressional Budget Office
* Including positive impacts on the economy; ** Bipartisan acts passed in 2018.
Sources: CBO and Desjardins, Economic Studies

Limited Erosion Thanks to Economic Growth

As we saw, the forecast budget costs of the measures recently introduced by the Trump administration and Congress are lessened by the expected positive impacts on economic growth. The CBO also substantially increased its forecast for GDP growth. In its last forecasting exercise in June 2017, the CBO was calling for an annual change of 2.2% in 2018 and 1.7% in 2019. The new forecasts are calling for gains of 3.3% and 2.4%, respectively. Much of the change comes from the hoped-for impact of the tax cuts and increases in spending (graph 9 on page 4). However, the long-term consequences are more negative.

Following the publication of the first estimates of the budget cost of the tax cut law and recent spending laws, we were able to project that the deficits would exceed US\$1,000B as of fiscal 2019, which will begin in October. Publication of the CBO’s latest forecasts has eased these fears. The stronger-than-expected economic growth has something to do with it.

GRAPH 9
Tax cuts and increased spending are a clear support to short-term growth



CBO: Congressional Budget Office; * Without stating the magnitude, the CBO believes that the increase in spending in 2018 and 2019 will have a negative impact on growth in subsequent years.
 Sources: CBO and Desjardins, Economic Studies

Adding the gross cost of the latest legislative changes to last year's baseline scenario yields a deficit of US\$834B in 2018 and US\$1,148B in 2019. As a % of GDP (using those forecast last year), the deficits would go from 3.5% in 2017 to 4.2% in 2018 and 5.6% in 2019. To keep U.S. public finances from skidding even more, we must hope that the economic forecasts hold up.

In the near term, moreover, the CBO's forecasts are a little more optimistic than other forecasters'. In fact, only the White House calls for similar or even greater growth, in its 2019 budget proposal (table 1).

Somewhat weaker economic growth than forecast would of course have an impact on public finances, and make for smaller

budget revenue, among other things. A sharp slowdown would also trigger further spending increases. The White House's Office of Management and Budget (OMB) estimates that growth that is 1% weaker for one year with no subsequent change (return to the initial growth forecast without a rebound) would trigger a net budget cost over 10 years of US\$802B. Assuming that the economic cycle will eventually end in the United States, we can easily see that, without further legislative adjustments, public finances could be in an even worse situation.

What about the Debt?

Inevitably, ballooning annual deficits will have a direct impact on U.S. federal government debt. Its gross debt exceeded US\$20,000B during 2017. It stood at US\$21,090B at the end of March 2018. The federal government itself holds much of this debt in various dedicated funds. It is therefore more interesting to look at the publicly-held debt, which went from US\$14,673B at the end of fiscal 2017 to US\$15,428B at the end of March 2018.

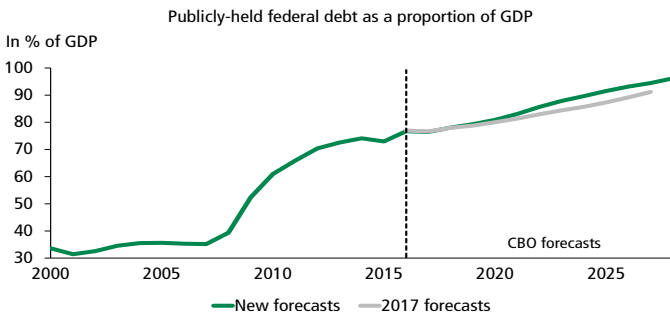
The CBO expects the publicly-held debt to rise from US\$15,668B—when fiscal 2018 ends on September 30—to US\$28,671B in 2028. As a proportion of GDP, the debt will thus go from 76.5% in 2017, to 78.0% in 2018, and 79.3% in 2019, peaking at 96.2% in 2028. This is a net deterioration from what the CBO forecast during last year's exercise. For 2027, US\$1,563B has thus been added to the forecast debt. As a proportion of GDP, the difference is 3.3% (graph 10 on page 5). Recall that the CBO scenario counts on continuous growth, without any economic setback.

TABLE 1
Real GDP forecasts

| | PERIOD | 2018 | 2019 | 2020 |
|--|---------------|------|------|------|
| ANNUAL VARIATION IN % | | | | |
| | y/y | | | |
| CBO forecasts | April 2018 | 3.0 | 2.9 | 2.0 |
| White House forecasts | February 2018 | 3.0 | 3.2 | 3.1 |
| IMF forecasts | April 2018 | 2.9 | 2.7 | n/a |
| Desjardins forecasts | April 2018 | 2.8 | 2.5 | 1.9 |
| Bloomberg Consensus forecasts | April 2018 | 2.8 | 2.5 | 2.1 |
| ANNUAL VARIATION IN % IN Q4 | | | | |
| | Q4/Q4 | | | |
| CBO forecasts | April 2018 | 3.3 | 2.4 | 1.8 |
| White House forecasts | February 2018 | 3.1 | 3.2 | 3.1 |
| IMF forecasts | April 2018 | 3.0 | 2.3 | n/a |
| Desjardins forecasts | April 2018 | 2.7 | 2.4 | n/a |
| Bloomberg Consensus forecasts | April 2018 | 2.7 | n/a | n/a |
| Median forecast of the Federal Reserve | March 2018 | 2.7 | 2.4 | 2.0 |

CBO: Congressional Budget Office; IMF: Fonds monétaire international; n/a: not available
 Sources: CBO, Office of Management and Budget, IMF, Bloomberg, Federal Reserve Board and Desjardins, Economic Studies

GRAPH 10
The debt will increase substantially



CBO: Congressional Budget Office
Sources: CBO and Desjardins, Economic Studies

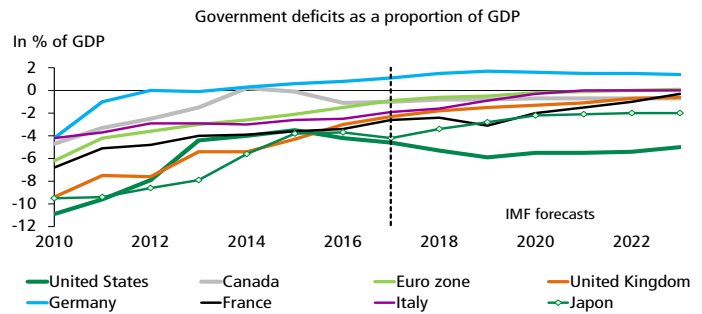
The ballooning debt could trigger new battles over the legal debt ceiling. For now, the 2018 bipartisan budget agreement has suspended the debt ceiling until March 1st, 2019. However, the cap will eventually be revisited and will have to be officially raised, a debate that easily gets U.S. politicians hot under the collar.

The erosion of U.S. public finances is a contrast with the improvement seen in several advanced countries. According to the International Monetary Fund's (IMF)³ forecasts, the euro zone could reach a balanced budget at the start of the next decade, and Canada and even Japan will be close, while the United States will slide deeper (graph 11). Only U.S. debt will continue to worsen (graph 12).

Despite its current and expected magnitude, the large U.S. debt does not pose a financing problem. The federal government still has a good credit rating (even though Standard & Poor's downgraded it in 2011 after the debt ceiling crisis). Interest rates on bonds remain low. However, how the situation will evolve remains to be seen. Will demand for U.S. bonds be enough to meet the supply resulting from the higher debt, without taking interest rates up sharply? The baseline scenarios are banking on some continuity with bond yields, which are primarily subject to movement by the economy and inflation. However, some pressure could eventually be felt on the cost of financing the debt. Moreover, emerging countries, particularly China, may not want to keep providing substantial financing to the U.S. government. There is also the fact that the Fed is now striving to (slowly and gradually) offload the federal bonds acquired following the financial crisis.

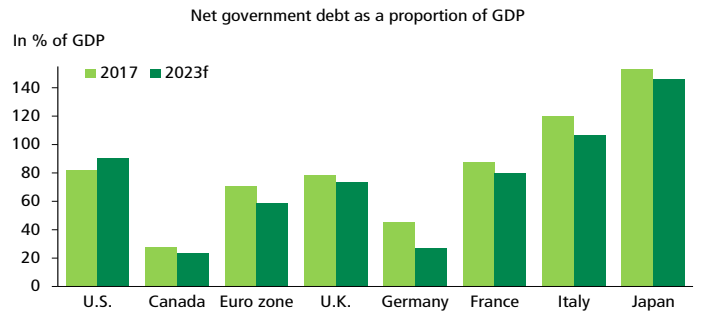
Note, too, that servicing the federal debt will be increasingly expensive for the government. The CBO expects 10-year bond yields to go from 2.3% in 2017 to 4.2% in 2022. Short-term

GRAPH 11
The United States is the odd man out in terms of its deteriorating public finances



IMF: International Monetary Fund
Sources: IMF and Desjardins, Economic Studies

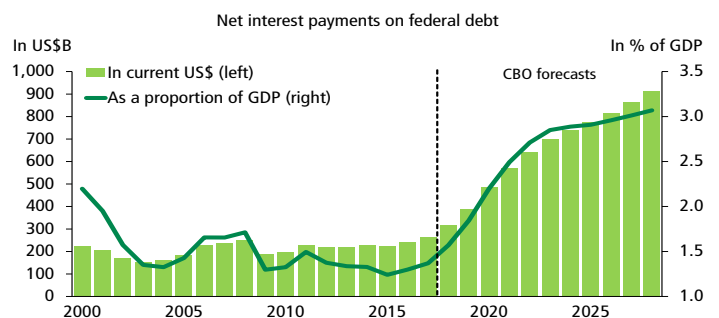
GRAPH 12
Only U.S. debt is still rising as a proportion of GDP



f: IMF forecasts; IMF: International Monetary Fund
Sources: IMF and Desjardins, Economic Studies

rates will rise from 0.7% to 3.8% over the same period. The larger debt and higher rates mean that debt service will rise from US\$263B in 2017 to US\$915B in 2028, according to the CBO's forecasts. As a % of GDP, the increase goes from 1.4% to 3.1% (graph 13). Once again, we have to hope that the forecasts hold up and interest rates do not increase too much. According to the OMB, rates 1% higher than in the baseline scenario add another US\$1,258 to the total deficit over 10 years.

GRAPH 13
Debt service will be increasingly costly



CBO: Congressional Budget Office
Sources: CBO and Desjardins, Economic Studies

³ The IMF's forecasts differ from the CBO's, among other things for the purpose of international comparisons, but also because they include all public administrations.

Conclusion: An Even Tougher Public Finance Challenge

With its latest decisions on tax cuts and higher spending, the U.S. federal government has put itself in a situation of procyclical deterioration in public finances. The advantage is that it increases economic activity in the short range, as can be seen in the widespread increase in growth forecasts for 2018 and 2019. What remains to be seen is whether the gamble is justified, or whether the erosion of public finances will come back to haunt the economy later. At this stage in the economic cycle, the aim should be to capitalize on economic growth to decrease budgetary shortfalls; this would help deal with eventual cyclical shocks.

If the situation eventually has to be cleaned up, it will be hard to reconcile the choices of the various U.S. political factions. Low tax rates, financing defence, the sanctity of social programs: all have their staunch defenders. Market pressures, the needs resulting from economic conditions, and the heavy long-term cost of population ageing could, however, force the political class to make some painful choices in the fairly near future, something the current elected representatives have not wanted to do.

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