Economics

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The Federal Budget Deficit Is Widening. Why, and Does It Matter?

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Summary

- The federal budget deficit has been on a rollercoaster ride over the past few years. The deficit widened from 4.6% of GDP in fiscal year (FY) 2019 to 15% in FY 2020 amid the economic carnage of the pandemic and the enormous fiscal aid distributed in response. The robust economic recovery and expiration of many pandemic-era fiscal initiatives helped push the deficit back down to pre-pandemic levels in FY 2022.
- The moderation in the budget deficit ended this year. Today, the federal budget deficit is an eye-popping 8.6% of GDP, or 7.1% of GDP when adjusting for the Supreme Court's decision to strike down President Biden's student loan forgiveness plan. What is driving this deficit widening?
- Receipts have fallen from supercharged levels (~19.5% of GDP in FY 2022, near the highs of the 1990s tech boom) back toward their long-run average of 17.4% of GDP. Tax revenues from workers' paychecks and corporate profits have held up well, but declining receipts from capital gains income, surging business tax refunds and falling Federal Reserve remittances have driven much of the 10% decline in receipts this year.
- On the outlays side of the ledger, there is no one single driver that has pushed up non-interest spending relative to before the pandemic. Outlays for entitlement programs such as Social Security and the major health care programs, national defense, veterans and several other spending categories have grown at a steady clip.
- Interest spending has jumped amid much higher rates. The federal government spent about 1.8% of GDP on interest expense in FY 2019. Through the 12 months ending this June, net interest costs had risen to 2.3% of GDP. The good news is that this remains below the highs seen during the 1980s and 1990s despite a debt-to-GDP ratio that is much higher today. The bad news is that interest costs are likely to keep rising in the near-term as maturing debt is steadily reissued at today's higher rates.
- On balance, federal budget deficits in the range of 6-7% of GDP appear likely for at least the next few years. If realized, this would put the annual budget deficit as a share of GDP about two percentage points wider than it was before the pandemic and nearly double the average deficit over the past 50 years.
- Large budget deficits may put upward pressure on Treasury yields. A general rule of thumb that emerges from the research literature is that a one percentage point increase in the structural budget deficit is associated with an increase in longer-term yields on Treasury securities of roughly 15-30 bps, all else equal. Higher Treasury yields would in turn increase borrowing costs throughout the economy.
- Of course, Congress could act to reign in the projected budget gap, either by increasing tax revenues, reducing spending or some mix of the two. But, the prospects for that seem unlikely between now and the 2024 election in our view, meaning 2025 is perhaps the earliest we might see some meaningful efforts at fiscal consolidation.
- Fortunately, the United States' ability to finance these deficits is supported by the world's largest economy, which generates $27 trillion of GDP annually and possesses over $150 trillion of household net worth. The U.S. dollar remains the world's reserve currency with no obvious alternatives in sight, and the market for U.S. Treasuries is the world's deepest, most liquid bond market. These factors seem unlikely to change anytime soon, but the sizable medium- to longer-run fiscal imbalance poses a potential structural headwind for the U.S. economy.

Red Ink Rising

The budget deficit narrowed in FY 2022 as the economy recovered and as many pandemic-era fiscal initiatives expired. The moderation in the budget deficit ended this year.

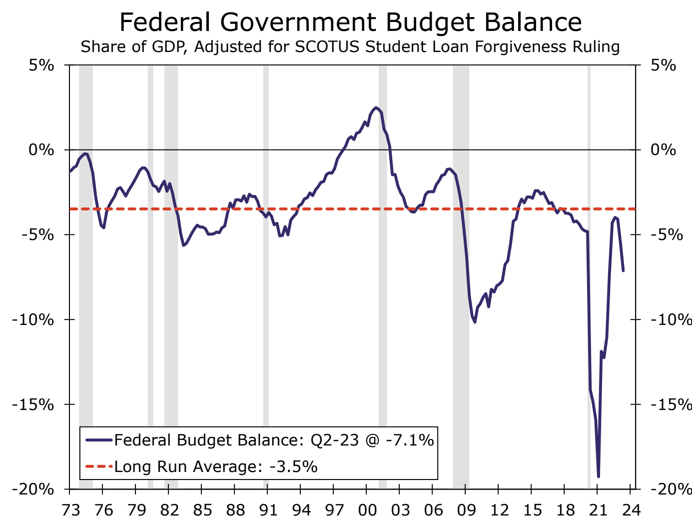
Monetary policy has been front and center over the past 18 months as the Federal Reserve has executed a historically rapid tightening cycle. Against this backdrop, fiscal policy frequently has received less attention than its monetary policy sibling. Yet in recent months, fiscal policy has emerged back into the spotlight. A pronounced debt ceiling fight occurred throughout the spring of this year, eventually culminating in a last second bipartisan deal to suspend the debt ceiling until January 1, 2025. A potential government shutdown looms on the horizon if Congress cannot pass a continuing resolution or the 12 annual appropriation bills by October 1. On August 1, Fitch Ratings downgraded the U.S. sovereign credit rating from the highest rating of "AAA" to "AA+". Fitch cited the "steady deterioration in standards of governance" over the last 20 years as one reason for its downgrade.[1]

But, the downgrade was not only due to elevated partisan rancor. Fitch also pointed to a "high and growing general government debt burden" and an "expected fiscal deterioration over the next three years." These points were punctuated on August 3 when the U.S. Treasury announced larger-than-expected auction sizes for Treasury security issuance in the coming months. The 10-year Treasury yield, which was already high by the standards of recent history, has climbed further since the end of July and currently stands at 4.30%, near the highest levels since the 2007-2009 financial crisis.

The federal budget deficit has been on a rollercoaster ride over the past few years. The budget deficit was 4.6% of GDP before the pandemic in fiscal year (FY) 2019, somewhat bigger than the 3.5% averaged over the past 50 years. In FY 2020, the budget deficit exploded to 15% of GDP amid the economic carnage of the pandemic and the enormous fiscal aid distributed in response (Figure 1). But by FY 2022, the budget deficit had receded to 5.5% of GDP and just 4.0% of GDP when adjusting for the costs of President Biden's student loan forgiveness plan, which were recorded last year when the plan was announced but did not come to pass due to the Supreme Court's decision to strike down the executive action.[2]

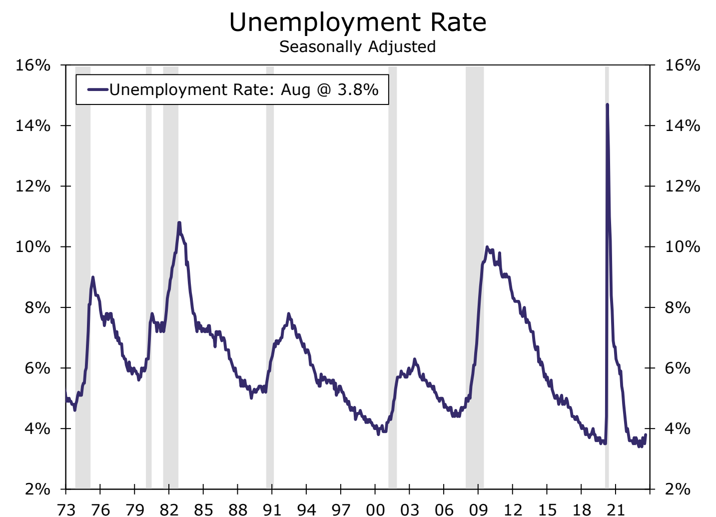
The moderation in the budget deficit ended this year. Today, the federal budget deficit is an eye-popping 8.6% of GDP, or 7.1% of GDP when excluding the aforementioned student loan forgiveness costs. Deficits of this size are much bigger than the pre-pandemic norm and are occurring at a time of low unemployment and solid GDP growth (Figure 2). This in turn raises questions about the medium- to longer-run fiscal outlook given an already large deficit, a steadily aging population and interest rates that appear to have broken out from their structural decline over the past several decades. In this report, we first identify the drivers of the widening budget deficit over the past year. We then discuss the outlook for the medium- to longer-run fiscal picture as well as implications for the U.S. economy.

Figure 1



Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Economics

Figure 2



Source: U.S. Department of Labor and Wells Fargo Economics

Federal Tax Revenues Are Returning to "Normal" Levels

Before the pandemic, federal receipts as a share of the economy were hovering near 16%, about a percentage point below the average over the previous 50 years of 17% of GDP (Figure 3). Unsurprisingly, federal tax collections were subdued in 2020 amid the economic devastation of the pandemic. However, the robust economic recovery that occurred in 2021 and 2022 led to a surge in federal receipts. By mid-2022, revenues as a share of GDP were about 19.5%, well-above pre-pandemic levels and approaching the highs reached during the tech boom of the late 1990s. In dollar terms, total federal tax revenues rose from $3.5 trillion in FY 2019 to $4.9 trillion in FY 2022, a nearly $1.5 trillion increase in just three years.

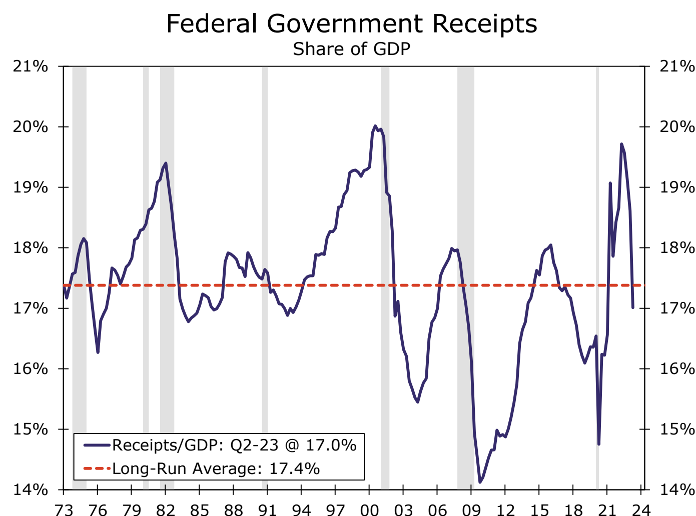
Over the past year, federal receipts have come back down to Earth from supercharged levels in FY 2022.

Over the past year, federal receipts have come back down to Earth. Revenues are down more than $400 billion (-10%) fiscal year to date. What is driving this decline?

Paycheck Withholdings Not the Problem

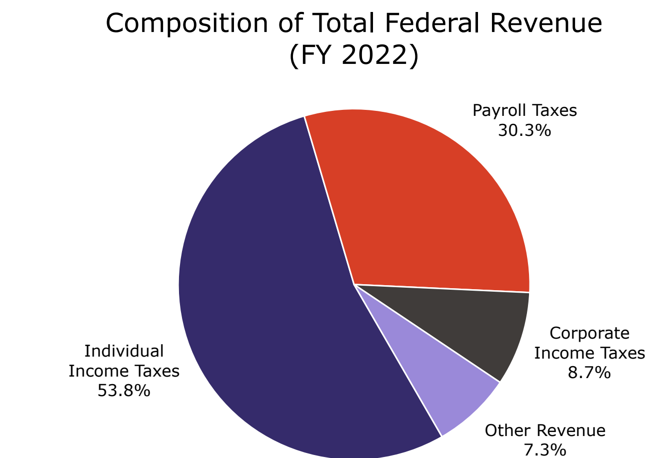
Individual income and payroll tax collections comprise the bulk of federal revenues. In FY 2022, these taxes accounted for 84% of federal receipts (Figure 4). Income and payroll tax collections withheld from workers' paychecks have grown about 4% through the first 11 months of FY 2023, roughly in line with the growth in aggregate labor income. Thus, withheld tax receipts have not been a contributor to the deficit widening seen this year.

Figure 3



Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Economics

Figure 4



Source: Congressional Budget Office and Wells Fargo Economics

Non-Withheld Tax Receipts Have Fallen Substantially

However, non-withheld individual income and payroll tax collections have been much weaker this year and are down nearly $300 billion (-26%) fiscal year to date. One driver of his trend appears to be a decline in tax collections on capital gains. Robust asset price returns in 2021 led to soaring non-withheld tax payments in the 2022 tax filing season, and the much weaker returns in 2022 have caused capital gains tax revenues to fall precipitously in 2023 (Figure 5). The delay of the tax filing deadline until October 16 in a handful of places that have been impacted by natural disasters, most notably in populous California, may also be playing a role. Non-withheld income tax receipts are still running above pre-pandemic levels, but the drop relative to last year has contributed to the roughly $400 billion decline in total federal receipts fiscal year to date.

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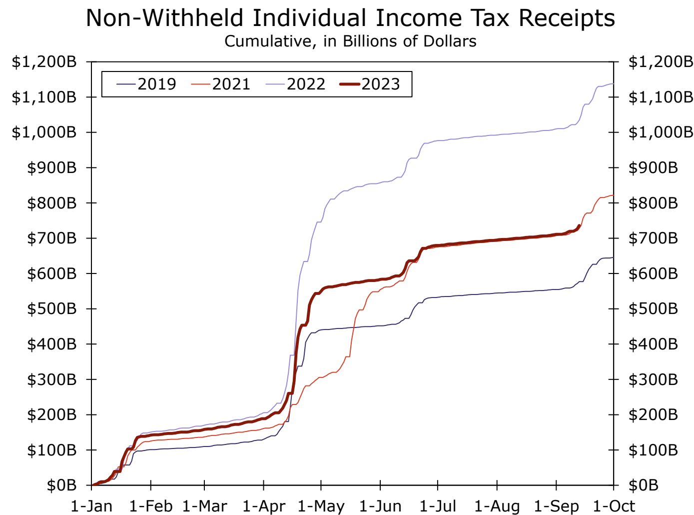
Business Tax Refunds Have Been Surging

Another important driver of the near-term fiscal deterioration has been much larger tax refunds for businesses. Business tax refunds have surged this year and are running at nearly double the pace seen in 2022 and four times the pace seen in 2019 (Figure 6). The reason for this run up in refunds seems to be delayed take up of COVID-era tax credits, particularly the Employee Retention Tax Credit (ERTC). The ERTC is a refundable tax credit for businesses that continued to pay employees amidst pandemic

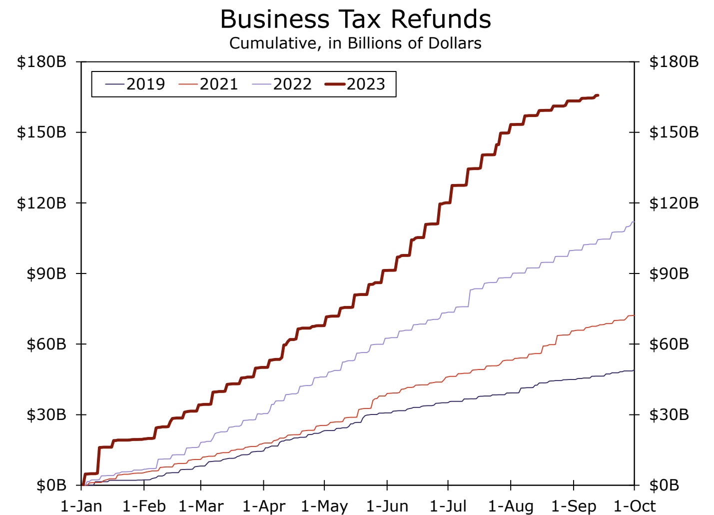
shutdowns or that experienced significant declines in sales due to the lockdowns in 2020 and 2021.[3] Businesses have until April 2024 to claim the credit for 2020 tax returns and until April 2025 for 2021 returns. Numerous businesses appear to be taking advantage of this opportunity to amend their old returns.

Figure 5



Source: U.S. Department of the Treasury and Wells Fargo Economics

Figure 6



Source: U.S. Department of the Treasury and Wells Fargo Economics

The size of this credit should not be underappreciated, and the ERTC is a good example of the fiscal tailwinds that are still blowing, even if they are no longer the gale force winds experienced early in the pandemic. When the ERTC first became law as part of the CARES Act in April 2020, the Joint Committee on Taxation estimated it would decrease revenues by $55 billion over the subsequent decade.[4] Later amendments to the eligibility and refund amounts as well as extensions of the sunset date added $30.9 billion to the estimated cost.

As of March 3, the Internal Revenue Service (IRS) reported that $153 billion had been claimed using the ERTC, and the strong business refund data over the past six months suggest this has only trekked higher by tens of billions of dollars since the last IRS update.[5] The IRS has signaled that it is slowing the processing of these claims to guard against fraud and incorrect submissions, so the recent pace may not extrapolate forward, but the ERTC has played a role in the fiscal deterioration this year.[6]

Federal Reserve Remittances Have Collapsed

Another drag on the revenue numbers is the Federal Reserve's earnings situation. Like a private bank, the Federal Reserve earns income on most of its assets (mostly Treasury securities and mortgage-backed securities) and pays interest on some of its liabilities (predominantly bank reserves and reverse repurchase agreements). When interest income exceeds interest expense, these earnings (minus operational costs) are remitted to the U.S. Treasury and counted as receipts for the federal government. At the peak in early 2022 before the FOMC began its tightening cycle, the Federal Reserve was remitting more than $100 billion in earnings to the Treasury on an annual basis. However, these earnings have evaporated as the Federal Reserve's interest costs on its liabilities now exceed the interest it receives on its loans and security holdings (Figure 7).

Altogether, these factors have pushed federal receipts as share of GDP down from their recent highs and much closer to the historical average of 17.4% of GDP.

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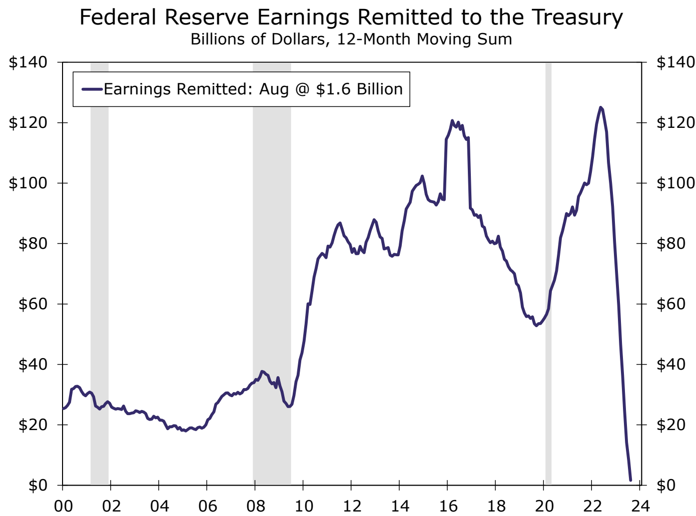
Figure 7



Source: U.S. Department of the Treasury and Wells Fargo Economics

Non-Interest Spending: Growing Across-the-Board

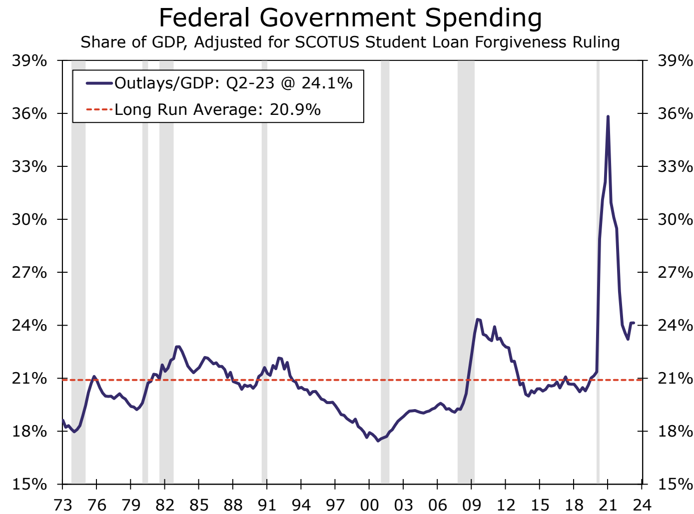
Federal government spending exploded at the onset of the pandemic, reaching highs not seen since World War II as the government provided trillions of dollars of support to households, businesses and state & local governments (Figure 8). Government spending as a share of GDP has receded materially as the economy has recovered and most COVID-era spending initiatives—such as the Paycheck Protection Program, enhanced unemployment benefits and direct checks to households—have run their course. That said, spending as a share of GDP is still about three percentage points above pre-pandemic levels, contributing to the deficit widening pre/post-pandemic. A portion of the increase in spending can be attributed to interest costs, a topic to which we will turn in the next section. What is driving the increase in non-interest spending?

Government spending as a share of GDP is still about three percentage points above pre-pandemic levels, contributing to the deficit widening pre/post-pandemic.

There Is No One Single Driver That Has Pushed Up Non-Interest Spending

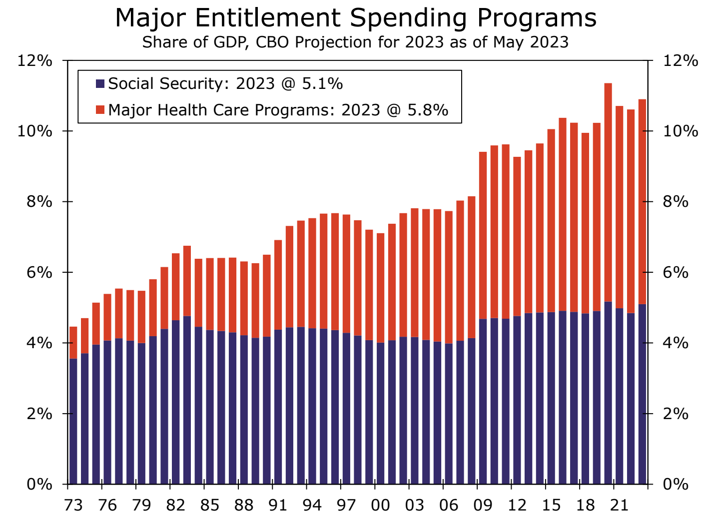
Social Security spending (+11% fiscal year to date) has jumped this year amid steady enrollment growth and a sizable 8.7% cost-of-living adjustment for beneficiaries. Spending on the major health care programs such as Medicare (+18%) and Medicaid (+5%) also has grown at a robust clip. Taken together, the Congressional Budget Office (CBO) projects federal spending on Social Security and the major healthcare programs will be 10.9% of GDP in FY 2023, an increase from 10.2% in FY 2019. The steady growth in spending on these entitlement programs remains both a near-term and long-term source of upward pressure on federal spending growth (Figure 9).

Figure 8



Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Economics

Figure 9



Source: Congressional Budget Office and Wells Fargo Economics

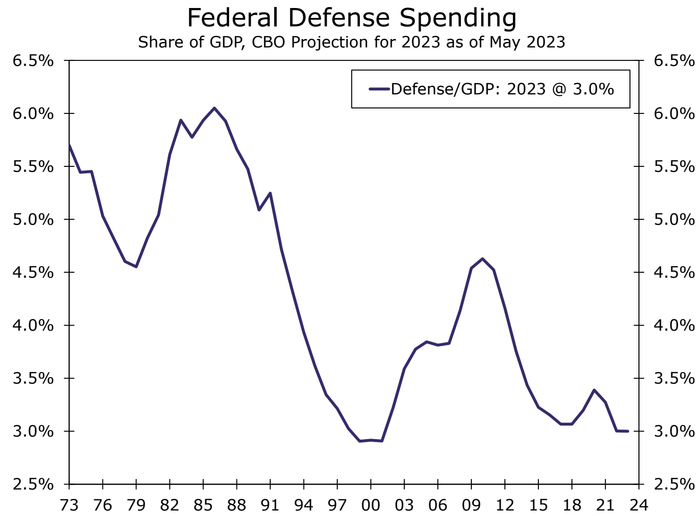
It Is Not Just Social Security, Medicare and Medicaid

Defense spending is up about 7% this fiscal year, in part due to aid for Ukraine in its war against Russia.

Defense spending is up about 7% this fiscal year, in part due to aid for Ukraine in its war against Russia. Despite the increase, defense spending as a share of GDP is actually a touch lower today (3.0%) than it was in FY 2019 (3.2%). (Figure 10). Defense spending as a share of the economy has been on a downward descent for decades, and the funding for Ukraine has not materially changed this trend. The bipartisan infrastructure bill that became law in 2021 also does not appear to be a major driver of the deficit widening. In February, CBO projected that outlays related to this law would be just $21 billion in FY 2023, up from $3 billion in FY 2022 but still less than 0.1% of GDP. A subsequent update from CBO in May anticipated an even slower pace of spending on programs funded by the Infrastructure Investment and Jobs Act. Infrastructure spending should ramp up over the next few years, with a peak spend out rate of $50-$75 billion per year.

A few other indiosyncratic factors also have driven up non-interest spending growth this year. Outlays of the Federal Deposit Insurance Corporation are up by $52 billion as a result of the bank failures in the spring, though the FDIC expects to recover much of that amount over the next several years. In the first 11 months of fiscal year 2022, auctions of licenses to use the electromagnetic spectrum for wireless and broadcast services brought in $81 billion, but there have been no such collections this year. Spending on military veterans is also up $31 billion this fiscal year (13%) amid increased use of services and policy changes that have increased spending per veteran.

Figure 10



Source: Congressional Budget Office and Wells Fargo Economics

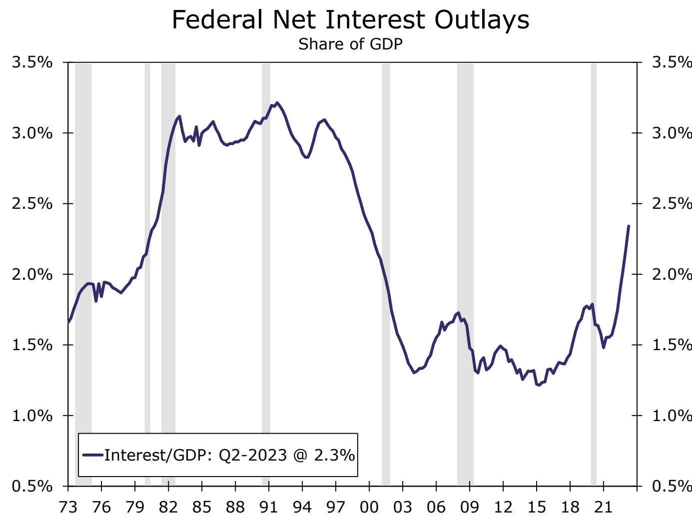
Interest Spending: The Latest Fiscal Challenge

Federal interest spending has garnered a significant amount of attention this year, and understandably so. The federal government incurred about $375 billion of net interest costs in FY 2019, about 1.8% of GDP. Through the 12 months ending this June, net interest costs had risen to $616 billion or 2.3% of GDP (Figure 11). The good news is that this remains below the highs seen during the 1980s and 1990s despite a debt-to-GDP ratio that is much higher today (95% today compared to an average of 38% from 1980 through 1995). The bad news is that interest costs are likely to keep rising in the near-term as maturing debt is steadily reissued at today's higher market-prevailing rates. We expect net interest outlays as a share of GDP to be between 2.50% and 2.75% by year-end 2023.

The federal government incurred about $375 billion of net interest costs in FY 2019, about 1.8% of GDP. Through the 12 months ending this June, net interest costs had risen to $616 billion or 2.3% of GDP.

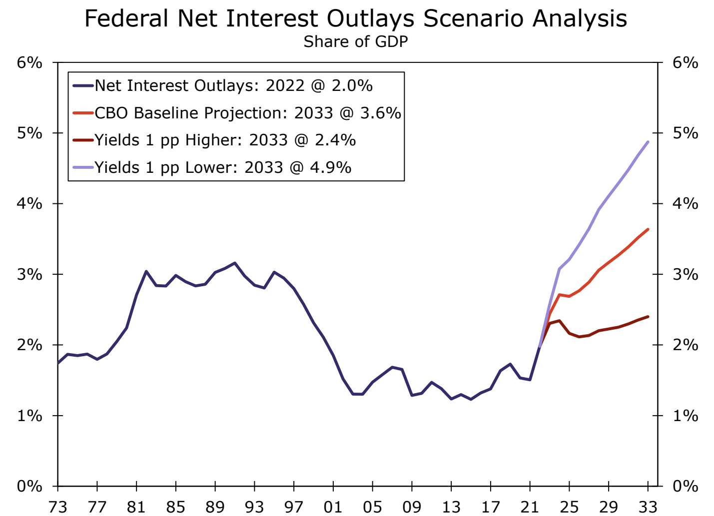
For 2024 and beyond, the outlook for federal interest spending is highly sensitive to assumptions about where interest rates will settle. The Congressional Budget Office's projections are illustrative in this regard. In its February 2023 budget and economic outlook, CBO's baseline projections assumed that short-term interest rates would gradually decline to 2.5% by 2025 and hold near that level in the years to follow. For longer-term rates, such as the yield on the 10-year Treasury security, CBO assumes a much higher rate of about 3.8% on average over the next decade. If realized, and when holding CBO's other economic and fiscal projections constant, net interest costs would rise to 3.6% of GDP by FY 2033. Scenario analysis from CBO suggests that if rates were instead one percentage point higher on average, net interest costs would rise to 4.9% of GDP by 2033, well above the highs seen in recent history (Figure 12). If instead interest rates were one percentage point lower, net interest costs would remain a more manageable 2.4% of GDP. Even in the latter scenario, which includes low rates more in line with the Treasury yields that prevailed in the 2010s, interest spending as a share of the economy would be above last decade's levels given the higher debt burden today.

Figure 11



Source: U.S. Department of the Treasury and Wells Fargo Economics

Figure 12



Source: Congressional Budget Office and Wells Fargo Economics

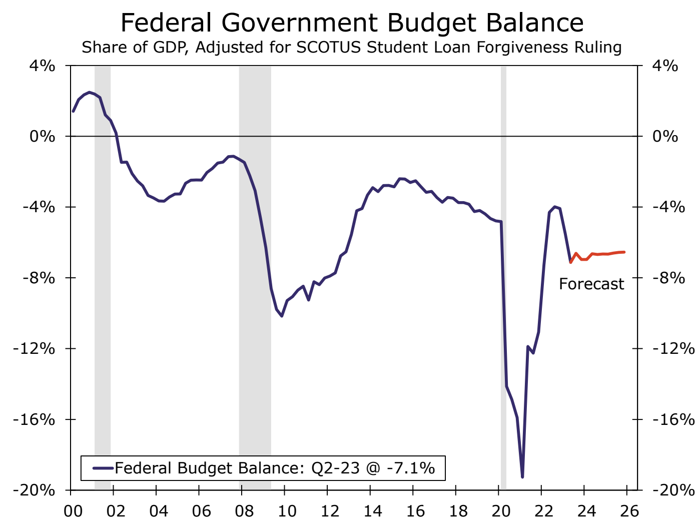
Outlook: Big Deficits Here to Stay

Our forecast is for the federal budget deficit to remain roughly flat in FY 2024 and FY 2025 around $1.9 trillion. This would put the annual deficit as a share of GDP roughly in the range of 6.5-7.0% of GDP, about two percentage points wider than FY 2019 and nearly double the average deficit over the past 50 years (Figure 13). We think the risks to this forecast are fairly balanced. If the U.S. economy achieves a "soft landing" and avoids a mild recession over the next couple of years, federal revenues may prove to be a bit stronger than we currently anticipate. However, we currently anticipate 225 bps of rate cuts from the FOMC next year in response to a recession. If no downturn materializes, we doubt the FOMC would cut rates by that much, and this in turn would create additional interest expense for the federal government relative to our baseline expectations. On net, we suspect this would probably be close to a wash. For now, sizable budget deficits seem here to stay.

For now, sizable budget deficits seem here to stay. Our forecast is for the federal budget deficit as a share of GDP to be roughly in the range of 6.5-7.0% over the next couple of years.

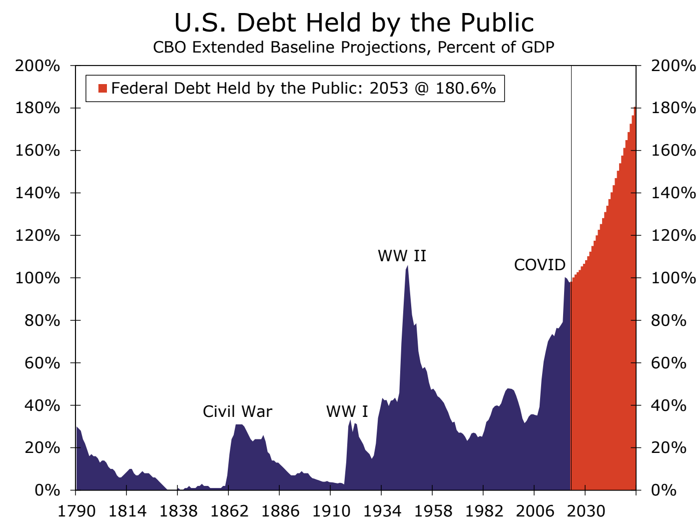
Large budget deficits may put upward pressure on Treasury yields. Economic theory and research suggests bigger deficits and higher public debt should be associated with higher interest rates, all else equal. Estimates on the magnitude of this impact vary depending on how each respective study treats the structural form of the variables (for example, deficits versus debt, or realized versus expected deficits), but generally speaking, the association between larger budget deficits and higher interest rates appears to stand when controlling for other factors. A general rule of thumb that emerges from the literature is that a one percentage point increase in the structural budget deficit is associated with an increase in longer-term yields on Treasury securities of roughly 15-30 bps.[7] The rise in yields in early August when government borrowing estimates surprised to the upside provides some real world evidence that the link between borrowing and rates is at least nonzero. Higher Treasury yields would in turn increase borrowing costs throughout the economy, reducing private investment and output growth.

Figure 13



Source: U.S. Department of the Treasury and Wells Fargo Economics

Figure 14



Source: Congressional Budget Office and Wells Fargo Economics

What about the outlook beyond 2025? Further out, the fiscal outlook will be determined by the evolution of key economic variables such as GDP growth, inflation and interest rates, as well as the decisions made by fiscal policymakers in Congress and the White House. An environment in which real interest rates are structurally higher could pose a new challenge to the fiscal outlook, although it would depend in part on what is driving real interest rates higher. For example, if the sustainable rate of economic growth in the United States is lifted by new technologies such as generative AI like ChatGPT, this would come with fiscal benefits (e.g., faster economic growth) even though it would probably raise real interest rates as we discussed in a recent special report.

In our view, it is unlikely there will be material fiscal consolidation between now and the 2024 presidential election. As a result, 2025 is the earliest we might see meaningful efforts at fiscal consolidation.

Of course, Congress could act to reign in the projected budget gap, either by increasing tax revenues, reducing spending or some mix of the two. But, the prospects for that seem unlikely between now and the 2024 presidential election in our view, meaning 2025 is perhaps the earliest we might see some meaningful efforts at fiscal consolidation. Notably, sizable portions of the tax cuts enacted in 2017 are set to expire at year-end 2025, so this could act as a catalyst for a broader agreement on changes to tax and spending policy going forward. Even still, the longer-run fiscal outlook appears concerning. CBO's long-term budget projections show the debt-to-GDP ratio rising to 181% by 2053, and this assumes the tax increases slated for 2026 occur as scheduled under current law (Figure 14).[8]

Fortunately, the United States' ability to finance these deficits is supported by the world's largest economy, which generates $27 trillion of GDP annually and possesses over $150 trillion of household net worth. The U.S. dollar remains the world's reserve currency with no obvious alternatives in sight, and the market for U.S. Treasuries is the world's deepest, most liquid bond market. These factors seem unlikely to change anytime soon, but the sizable medium- to longer-run fiscal imbalance poses a potential structural headwind for the U.S. economy.

Endnotes

1 - "Fitch Downgrades the U.S. Long-Term Rating to 'AA+'; Outlook Stable." Fitch Ratings. (Return)

2 - In September 2022, the Biden administration recorded an increase in outlays of $379 billion to reflect its estimate of the long-term costs of the proposed student loan debt cancellation plan. These higher outlays increased the FY 2022 budget deficit by a commensurate amount. However, this student loan forgiveness plan was struck down by the Supreme Court this summer. In August 2023, the Administration recorded a roughly $330 billion reduction in outlays for the student loan program to reflect the Supreme Court's decision. That action reduced the deficit for this fiscal year. For further reading on this topic, please see the Congressional Budget Office's Monthly Budget Review: August 2023. (Return)

3 - For further reading on the Employee Retention Tax Credit, see the section titled 'Employee Retention Tax Credit' starting on page 20 of this Congressional Research Service report from April 4, 2022: Payroll Taxes: An Overview of Taxes Imposed and Past Payroll Tax Relief. (Return)

4 - See The Joint Committee on Taxation. JCX-11R-20. "Estimated Revenue Effects Of The Revenue Provisions Contained In An Amendment In The Nature Of A Substitute To H.R. 748, The "Coronavirus Aid, Relief, And Economic Security ('CARES') Act," As Passed By The Senate On March 25, 2020, And Scheduled For Consideration By The House Of Representatives On March 27, 2020" April 23, 2020. (Return)

5 - Internal Revenue Service Data Book, 2022. Publication 55-B, Washington D.C. March 2023. (Return)

6 - Rubin, Richard, and Ruth Simon. "IRS Slows Refund Payments for Pandemic-Era Tax Break: Agency warns of fraud in employee-retention tax-credit program." The Wall Street Journal. September 5, 2023. (Return)

7 - Gamber, Edward and John Seliski. "The Effect of Government Debt on Interest Rates." Working Paper 2019-01, Congressional Budget Office. 2019. (Return)

8 - Congressional Budget Office. The 2023 Long-Term Budget Outlook. June 2023. (Return)

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