WELLS FARGO

Special Commentary — October 1, 2024

Happy Fiscal New Year!

Summary

Another federal fiscal year is in the books. Today marks the first day of FY 2025, and the new year is a time for reflecting upon the past year and looking ahead to the new one. With the 2024 presidential election just one month away, the U.S. fiscal policy outlook is sharply in focus. In this report, we have selected some of our favorite charts on U.S. fiscal policy and paired them with a short blurb highlighting some key trends in the finances of the federal government. We hope you find them informative and have a wonderful fiscal new year.

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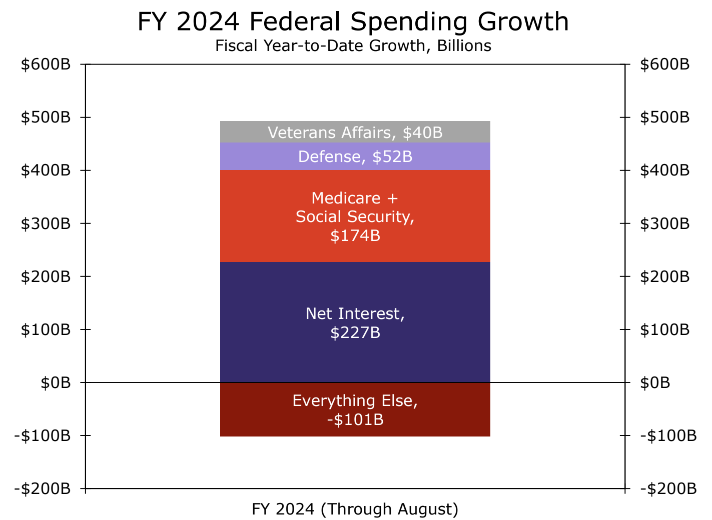
Where Did Spending Growth Come from in FY 2024?

Federal spending increased by $392 billion (+7%) through the 11 months of FY 2024 for which we have data. Outlay growth outpaced nominal GDP growth despite the latter being on track to grow by a very solid 5.5% in FY 2024. Yet, just a handful of spending categories have accounted for the entirety of the year's outlay growth. Interest spending on the national debt jumped by $227 billion, while spending on Social Security and health insurance for the elderly (Medicare) accounted for a combined $174 billion increase in expenditures. Spending on national defense (+$52 billion) and veterans (+$40 billion) also saw meaningful growth this fiscal year. But, beyond those categories, federal outlays on all remaining programs declined by roughly $100 billion.

Note: The chart and numbers above are adjusted to account for timing shifts and changes to student loan policy. In FY 2022, the federal government recorded a $379 billion cost from the Biden administration's student loan cancellation proposal. In June 2023, the Supreme Court prohibited much of the planned cancellation of student loan debt, which led to a recorded $330 billion in savings in August 2023. These figures adjust for these roughly offsetting swings.

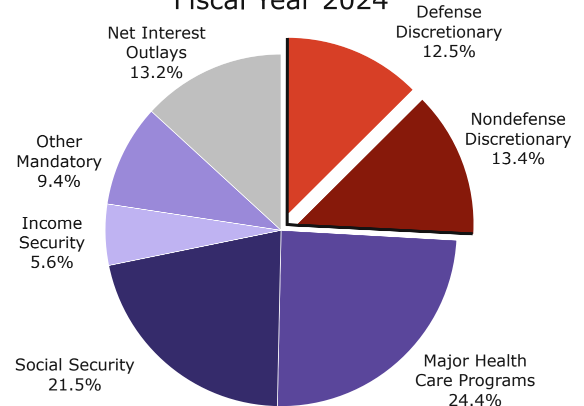


Source: Congressional Budget Office and Wells Fargo Economics

Don't Miss the Forest for the Trees

Federal government spending is typically characterized as either "mandatory" or "discretionary." Mandatory spending covers programs where total outlays are dictated by eligibility rules, such as age or income. Examples include Medicare (health insurance for elderly individuals) or Medicaid (health insurance for lower-income individuals). In contrast, discretionary spending is set each year by Congress. Congress sets a topline spending amount, and then that pot of money is allocated to various government programs and initiatives. As an example, most national defense activities fall into the discretionary category.

It is the discretionary section of the budget that tends to receive the most attention since these spending levels are set during the annual budget process. When headlines about a government shutdown loom large, policymakers are debating spending levels for the discretionary segment of the budget, while most mandatory spending occurs on autopilot from year-to-year. Yet, as the chart to the right shows, discretionary spending only accounts for about one-quarter of federal spending. Spending on Social Security, Medicare, Medicaid and civilian and military retirement benefits are not a part of this process despite accounting for the lion's share of federal expenditures.



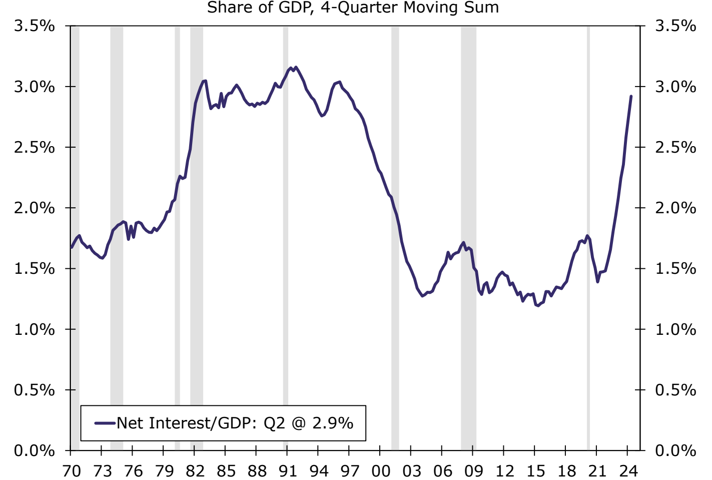
Source: Congressional Budget Office and Wells Fargo Economics

Based on CBO projections as of June 2024

Interest Piqued

Despite the federal debt-to-GDP ratio jumping roughly 35 percentage points in the five years following the start of the Great Recession, the ultra-low interest rate environment of the 2010s kept interest outlays as a share of GDP near historic lows. Yet, today's higher rate environment makes the ongoing climb in debt outstanding a different kettle of fish. The potent combination of another jump in debt outstanding (from 79% in 2019 to 95% in 2024) and interest rates near 15-year highs has led to a rocketing up in interest expense as a share of GDP. Interest expense has grown to account for 13% of all federal outlays over the past year.

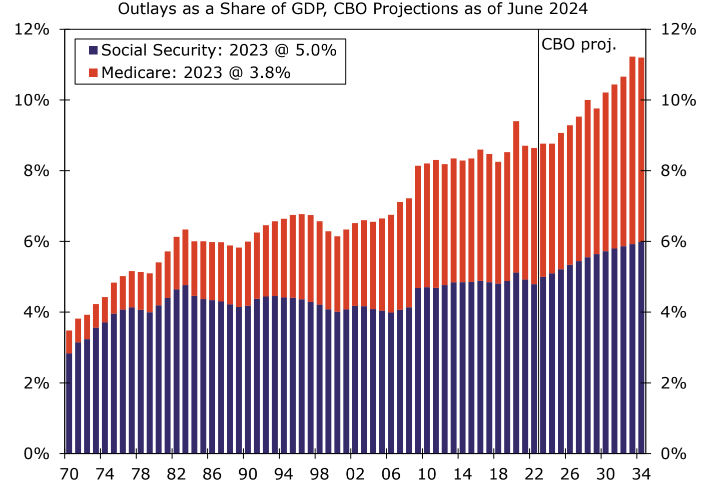
At a cost of $843 billion through the first eleven months of the fiscal year, interest outlays have surpassed national defense spending ($798 billion FYTD). While the start of the Fed's easing cycle may bring some relief to debt expenses in the near term, a return to the benign rates of the 2010s is unlikely to be in store in our view. Under CBO's baseline projection for the next decade, interest outlays as a share of GDP continue to climb, hitting 4.1% in 2034 under the assumption that the average interest rate on the federal debt is about 3.5%. Even under a more favorable alternative scenario of lower interest rates, the ratio drops back only to around 2.5%.



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

Rising Red Ink from a Graying America

Unlike interest expense, increasing deficit pressure from rising spending on mandatory spending programs is not a new phenomenon. The aging of the population and rising healthcare costs have propelled spending on Social Security and Medicare to new highs. In FY 2024, Medicare and Social Security likely will be about 8.8% of GDP. This compares to 8.3% in 2014 and 6.6% in 2004. CBO projects that the trend will continue and that these two spending categories will account for 11.2% of GDP in 2034, creating a structural source of bigger budget deficits in the absence of spending cuts elsewhere or higher tax revenues.

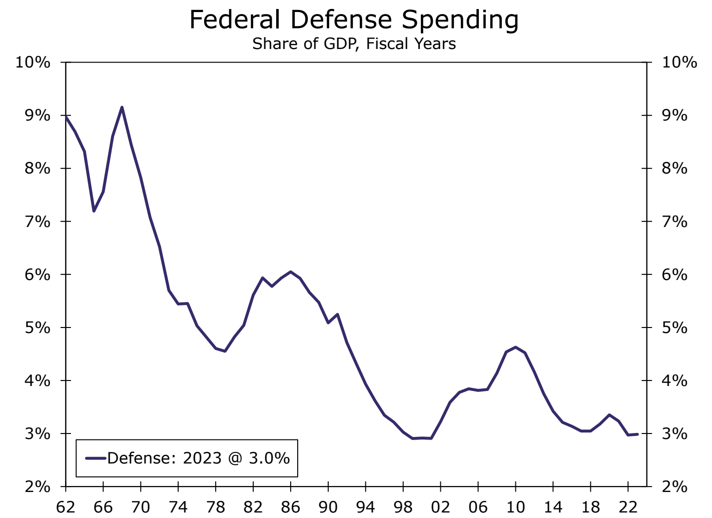


Source: Congressional Budget Office and Wells Fargo Economics

On the Defense

In the absence of any meaningful effort to curtail the structural rise in outlays due to mandatory spending, pressure to limit spending growth increasingly has been directed toward discretionary spending. For defense, more limited spending growth over the past decade has been facilitated by the winding down of the wars in Iraq and Afghanistan, similar to the "peace dividend" of the early 1990s following the fall of the Soviet Union and end of the Cold War. CBO estimates defense outlays were 3% of GDP this past fiscal year, near the post-WWII lows of the late 1990s that assisted in generating rare budget surpluses.

Yet, this relief valve for the deficit could be harder to rely on ahead with geopolitical risks on the rise. The ongoing war between Russia and Ukraine, conflicts in the Middle East, and tensions with China over Taiwan and the South China Sea point to a potentially more fraught security environment. Defense-related investment already shows signs of picking up. Amid a generally gloomy environment for industrial production, defense and aerospace output has risen 3.3% over the past year versus total manufacturing production being little changed.

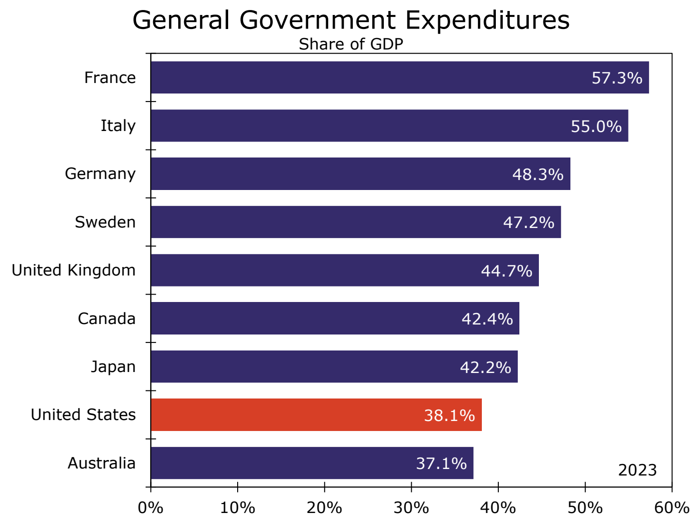


Source: Congressional Budget Office and Wells Fargo Economics

Peer Review

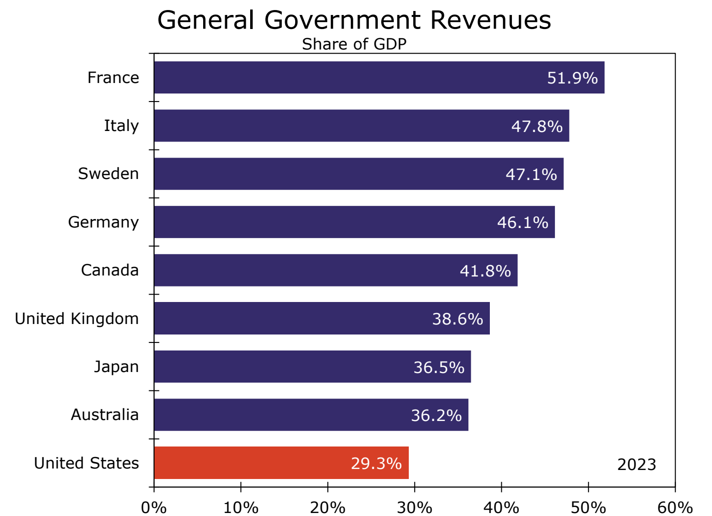
The United States government generally taxes and spends less than its largest advanced economy peers. U.S. government expenditures across all levels of government (i.e., the spending by central, state and local levels of government) were 38.1% of GDP in 2023, among the lowest of its peer countries. On the other side of the ledger, revenues as a share of GDP in the United States are lower than all of its peers in the G7 and materially below those of some higher-tax economies.

However, note that there are some countries where revenues and expenditures are higher as a share of GDP (e.g. Sweden) and lower (e.g. Australia), but the gap between receipts and outlays is much smaller than what is the case in the United States. This is indicative of a structural budget deficit that is larger in the United States than most of its peers.



Source: International Monetary Fund and Wells Fargo Economics

Note: 2023 actual values for Italy, Canada, the U.K. and Germany. IMF projected values for France, Japan, Australia, Sweden and the U.S. based on latest available data for 2023.



Source: International Monetary Fund and Wells Fargo Economics

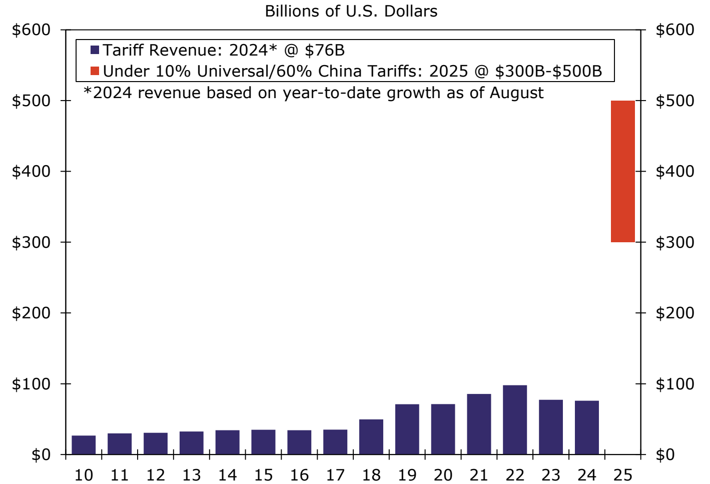
Note: 2023 actual values for Italy, Canada, the U.K. and Germany. IMF projected values for France, Japan, Australia, Sweden and the U.S. based on latest available data for 2023.

Taxing Trade

The trajectory for U.S. fiscal policy depends in part on the outcome of the November 5 election. One key change to revenue collection could come via international trade policy. Former President Trump has proposed a 10% tariff on all imports of foreign goods and a 60% tariff on Chinese goods.

If implemented in full, this proposal could lead to a significant increase in tax revenue. The federal government generated roughly $77 billion in tariff revenue in 2023. If Trump's proposed policy had been in place on the $427 billion American imports of foreign goods that came from China and the roughly $2.6 trillion of imports from all other countries, the U.S. government would have collected more than $500 billion in tariff revenue last year.

Of course, tariffs along these lines would cause imports into the United States to shrink, particularly from China, and as a result that $500 billion figure likely represents more of an upper-bound than a base case. As we wrote in a recent report, economic growth also would likely weaken, weighing on other sources of tax revenue. Nevertheless, the federal government would likely collect new tariff revenues worth hundreds of billions of dollars annually under Trump's proposal, a major increase relative to recent history.



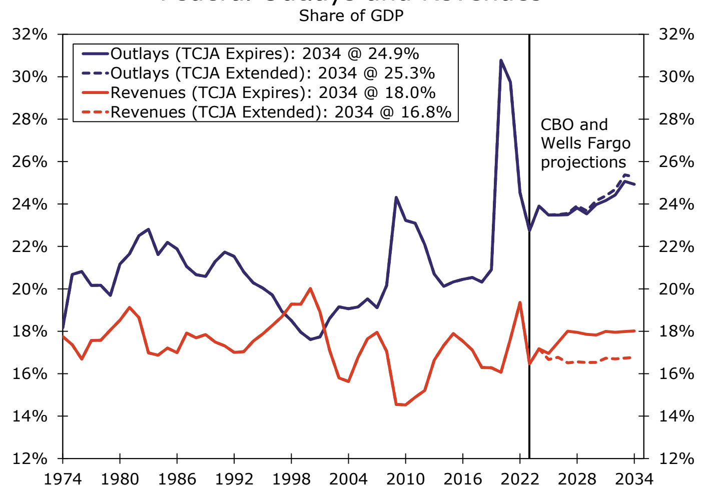
Source: U.S. Department of the Treasury, The Tax Foundation, The Tax Policy Center and Wells Fargo Economics

TCJA or No, Deficits Set to Grow

Tax revenues also could be boosted if Congress allows large parts of the Tax Cuts and Jobs Act (TCJA) to expire as scheduled at the end of 2025. Under a return of the tax code to its pre-2018 state, federal revenues as a share of GDP would rise to 18.0% over the next decade according to projections from CBO. This would put revenues slightly higher than the long-run average of roughly 17.3% of GDP.

The fiscal cost of extending the TCJA is sizable. If done without offsetting revenue raisers or spending cuts, a TCJA extension would cost roughly $4.6 trillion over the next decade and increase annual federal budget deficits to 7%-8% of GDP, a degree of borrowing unprecedented outside of wartime or recession. Even so, regardless of how fiscal policymakers deal with the looming TCJA debate, outlays are expected to continue to trend higher, ensuring historically large budget deficits in the absence of Congressional action.

For more analysis on the looming expiration of the TCJA, please see our recent report.

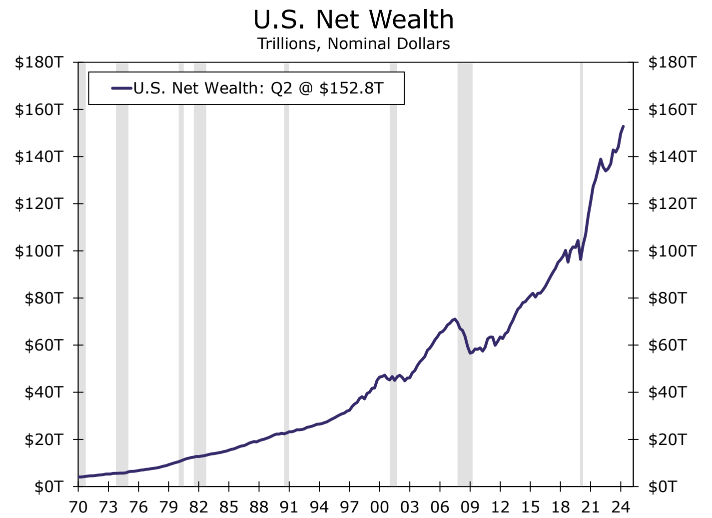


Source: Congressional Budget Office and Wells Fargo Economics

America Remains Tremendously Wealthy

There is plenty to be gloomy about when it comes to the U.S. fiscal policy outlook. But, it is not all bad news in our view. 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. The United States' ability to finance its budget deficits is supported by the world's largest economy, which generates $29 trillion of GDP annually and possesses a substantial amount of wealth. One simple measure of this bounty is U.S. net wealth. A country's net wealth is calculated by summing all of its private and public assets and subtracting out all of its liabilities to the rest of the world, including its sovereign debt. Despite the significant growth in federal government debt in recent years, U.S. net wealth has continued to trek higher and currently sits north of $150 trillion.

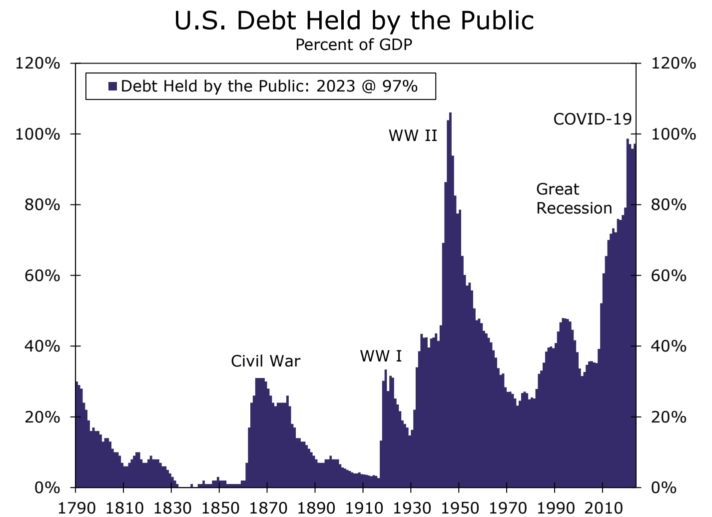
Some of this can be attributed to the continued rise in the value of many U.S. assets, such as real estate and equities. But, it is also important to remember that about two-thirds of the national debt is held by American individuals and institutions such as pension funds, banks, money market funds and life insurance companies. Although the national debt is a liability to the federal government, Treasury securities are also an asset to many American households and businesses.



Source: Federal Reserve Board and Wells Fargo Economics

Looking to History as a Guide

The U.S. government's debt-to-GDP ratio is historically high, but it is not without precedent. During and immediately after World War II, the federal government's debt was roughly the same size as the U.S. economy, just as it is today. It took the end of the war, low interest rates and a post-war productivity boom to reduce the debt-to-GDP ratio in the couple of decades after World War II. That said, even with those positive macro forces at work, it also took some tough policy choices regarding the government's revenues and outlays. Putting the U.S. on a sustainable fiscal trajectory once again will require some difficult decisions.



Source: Congressional Budget Office and Wells Fargo Economics

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