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READY FOR THEIR CLOSE-UP? DEFICIT & DEBT

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KEY TAKEAWAYS

The good news is that the deficit, debt, and pace of federal spending are not on the market's radar screen at this time.

Currently, the only way to change the course of the deficit and debt over the medium and long term is to cut spending or raise taxes (or both) via meaningful programs, and in Washington today, neither seems very likely.

The federal deficit and debt have not received much attention on the campaign trail this election cycle. Our August 22, 2016 *Weekly Economic Commentary, "Fiscal Policy—String Theory,"* provides some insight into the plans floated by both Hillary Clinton and Donald Trump to cut and/or reform taxes and make significant investments in the nation's infrastructure. The deficit and the debt did get a brief moment in the spotlight during the presidential debate season in September and October 2016, but have since faded into the background amid the general rancor of this year's campaign. Regardless of who wins the election this week, the new president and new Congress will face a rising deficit and many unanswered questions on the direction of the deficit and debt in the coming years and decades. In this week's commentary, we will answer several of the most frequently asked questions that come into the LPL Research Department on the deficit and debt.

WHAT'S THE LATEST ON THE BUDGET DEFICIT?

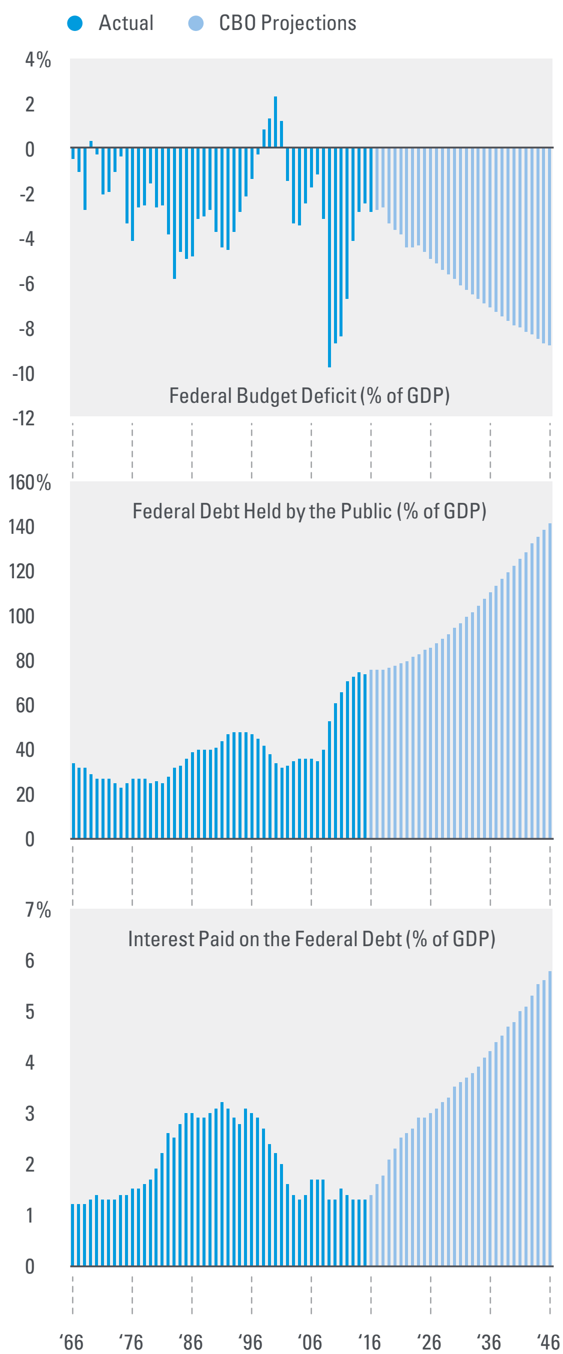
Later this week, on Thursday, November 10, 2016, the U.S. Treasury Department will release the budget data for the first month of Fiscal Year (FY) 2017, which began on October 1, 2016, and will end on September 30, 2017. As a reminder, the federal budget deficit in FY 2016, which ended on September 30, 2016, was $587 billion—$148 billion higher than in FY 2015. Federal government receipts fell 2% to $3.3 trillion in FY 2016 while federal outlays, including interest on the public debt, rose 18% to $3.8 trillion.

The $587 billion deficit in FY 2016 was equal to 3.2% of GDP, up from 2.5% of GDP in FY 2015. FY 2016 marked the first time since FY 2009 that the deficit increased from one year to the next. Looking ahead, the non-partisan Congressional Budget Office (CBO) expects the deficit in FY 2017 to widen out to $594 billion, but shrink as a share of gross domestic product (GDP) from the 3.2% reading in FY 2016 to 3.1% in FY 2017. Over the next 10 years, the CBO projects the deficit will hit $1.2 trillion or 4.6% of GDP. More disturbingly, under current law (absent any changes to laws governing taxes or spending) the CBO projects the deficit will hit 8.8% of GDP by mid-century.

HOW ABOUT THE DEBT?

As it stands today, financial markets are not overly concerned with budget deficits or the public debt (the total of the deficits and rare surpluses that have accumulated over the years). Financial market participants focus on the public debt-to-GDP

DEMOGRAPHICS ARE THE KEY DRIVER IN THE WORSENING BUDGET PICTURE IN THE COMING DECADES



Source: LPL Research, Congressional Budget Office 11/07/16

Projections set forth in the presentation may not develop as predicted.

Assumes no changes in the laws governing federal taxation or federal spending, and assumes no recession in the United States.

Interest Rate Assumptions: 2026–3.3%; 2046–5.8%

figure, which stood at $14.2 trillion (or 77% of GDP) at the end of FY 2016, up from $13.1 trillion (74% of GDP) at the end of FY 2015. The CBO projects that over the next 10 years (absent any changes in the laws governing federal taxation or federal spending and assuming no recession in the United States), the debt-to-GDP ratio will move to 86% of GDP, an 80-year high. By 2046, again assuming no changes to current law, the CBO projects the debt-to-GDP ratio will rise to 141% of GDP. The main driver of the higher debt-to-GDP ratio in the next 10 years, and indeed over the next several decades, is spending on Social Security, Medicare, and Medicaid, which is in turn largely driven by demographics. Spending cuts and tax increases related to these programs are the only way to arrest rising debt levels in the next 10 years and beyond.

WHAT ABOUT INTEREST ON THE DEBT?

In FY 2016, the federal government paid net interest of $240 billion on the federal debt, up from $223 billion paid in FY 2015. While the dollar amount of interest paid in FY 2016 ($240 billion) was near the all-time high of $252 billion back in 2008, it represents just 1.3% of GDP. At 1.3% of GDP, the federal government's net interest payments on the debt are the lowest in 40 years, and well below the recent peak of 3.2% of GDP hit in the mid-1980s through the mid-1990s.

Looking ahead, the CBO projects that net interest payments will rise to $712 billion by the end of FY 2026, doubling its size relative to GDP from 1.3% today to 2.6% by FY 2026. This projection assumes that the average interest rate paid on the federal debt moves from 2.0% today to 3.3% by 2026, as the yield on the 10-year Treasury note moves from 1.8% today to 3.6% by 2026, and the yield on the 3-month Treasury bill moves from around 0.35% today to 2.8% by 2026 [Figure 1]. As noted above, if the CBO's projections are correct, at 2.6%, the interest paid on the national debt in 2026 would still be below the recent peak of 3.2% of GDP hit in the mid-1980s through the mid-1990s under presidents Ronald Reagan and George H.W. Bush. By 2046, the CBO projects that the interest on the debt would rise to 5.8% of GDP.

WHAT ABOUT WASTE, FRAUD, AND ABUSE?

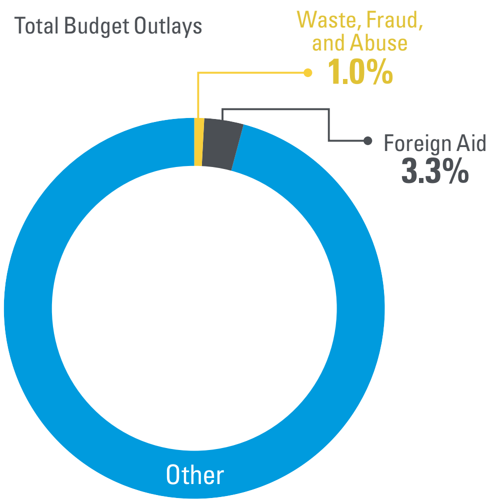
The libertarian Cato Institute, a Washington, D.C.-based think tank, estimates waste, fraud, and abuse in the federal budget at between $100 billion and $125 billion per year. The Government Accountability Office (GAO) estimated that waste, fraud, and abuse in the federal budget in 2014 was $125 billion. On an absolute basis, this is an enormous amount of money, and taxpayers and the financial markets would welcome any and all steps to eliminate this from the budget. However, the annual outlays of the U.S. federal government in FY 2016 were $3.8 trillion. So even if the federal government were able to eliminate every dollar of waste, fraud, and abuse in the budget, federal outlays in FY 2016 would still have been well over $3.6 trillion, and the federal deficit in FY 2016 would have been $462 billion instead of $587 billion [Figure 2].

HOW ABOUT FOREIGN AID?

Although not a single line item in the budget, foreign aid receives a great deal of attention in the media. A 2014 poll conducted by the Kaiser Family Foundation found that Americans thought that the United States spends 26% of its budget on foreign aid. The These outlays are found in the budgets of the U.S. Treasury, the Department of Agriculture, the State Department, and even the Department of Defense for items such as:

- Embassy security
- The Peace Corps
- Disaster assistance
- Peacekeeping
- Direct economic support to foreign nations
- The World Bank, IMF, and the United Nations
- Global health initiatives

2 THESE MAJOR POLITICAL HOT BUTTON ISSUES ARE NOT BIG DRIVERS OF THE BUDGET



Source: LPL Research, Congressional Budget Office 11/07/16

SHORT-TERM GAIN, LONG-TERM PAIN

In the aftermath of this week's presidential election, many market participants will be looking for the new Congress and the new president to work together to pass a fiscal stimulus package in an effort to reinvigorate economic growth. Such a package may include repatriation of overseas profits, broad-based corporate tax reform, and spending on the nation's rapidly aging infrastructure. While we (and markets) would welcome these steps, in the longer run, the U.S. federal budget outlook remains relatively bleak, largely driven by demographics.

As we wrote in our September 28, 2015 *Weekly Economic Commentary*, "Short-Term Gain, Long-Term Pain," the good news is that the deficit, debt, and pace of federal spending are not on the market's radar screen currently. The stable debt-to-GDP ratio over the remainder of the decade (as forecast by the CBO) also provides a window for Congress to address 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 non-defense discretionary spending. Any action to address the underlying structural issues in the budget are unlikely until after the 2016 presidential and congressional elections, but recent history suggests that Congress may not act until a crisis is already underway. The biggest risk 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.

CONCLUSION

The structural and demographic problems that will drive the deficit over the next several decades remain in place, and the longer policymakers wait to address them, the more difficult they become—and the more painful the solution. As it stands today, the only way to change the course of the deficit and debt over the medium and long term is to cut spending or raise taxes (or both) on sizable portions of the budget such as Social Security, Medicare, and Medicaid; and in Washington today, neither seems very likely. ■

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

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