

Mind The Gap:

Should We Worry About The U.S. Fiscal Situation?

The U.S. federal fiscal deficit surged to \$2 trillion in 2023 or 7% of U.S. gross domestic product (GDP).¹ Put another way, the U.S. Federal Government spent \$2 trillion *more* than it received in revenue during its 2023 fiscal year.

«THE U.S. FEDERAL GOVERNMENT SPENT \$2 TRILLION MORE THAN IT RECEIVED IN REVENUE DURING ITS 2023 FISCAL YEAR.»

For context, considering the U.S. is not at war or in a recession, the budget gap is enormous. Typically, in economic expansions, budget deficits narrow rather than widen.

Moreover, for our global clients and emerging market (EM) sovereign analyst-aficionados, growing fiscal deficits paint a worrying picture of an economy's underlying economic health and often put pressure on currencies. One emerging markets debt team member who attended the Fall 2023 International Monetary Fund meetings in Morocco reported that the U.S. fiscal situation topped the list of concerns of more than 300 institutional investors polled at the event.

U.S.-based investors are equally focused on the fiscal deficit. In August, due to the growing government debt burden, the credit rating agency Fitch downgraded U.S. Treasury debt from AAA to AA+. More recently, with U.S. fiscal deficits expected to remain significant, another credit agency, Moody's, also changed its U.S. credit outlook to negative, attributing the downgrade to "significantly weakening debt affordability."²

DID YOU KNOW?

DEFICIT DEFINITIONS

Economists and budget experts often use specific terms to discuss deficits, but what exactly does the jargon mean?

Deficit vs. Debt: A *deficit* occurs when the government spends more than it collects in revenue for a given year. It then issues *debt* to finance the deficit. The total debt issued plus the interest expense owed is the *national debt*. Economists prefer to report deficit and debt as a share of a nation's Gross Domestic Product (GDP).

Primary Deficit: The primary deficit is the current year's deficit minus *interest expenses*, which measures the government's actual revenue and spending in the current year, absent the effect of past borrowings.

Cyclical vs. Structural Deficit: *Cyclical deficit* measures the deficit accumulated from weak economic growth (e.g., lower income taxes collected during recessions). *Structural deficits* are more permanent, driven by fiscal policy or long-term factors. Tax cuts, defense spending, and rising healthcare due to older populations are examples of structural deficits.

Debt Held by the Public vs. Intragovernmental Debt: While the government issues debt to finance its cumulative deficits, some debt is held by private parties and local and state governments and is considered debt held by the public. Intragovernmental debt is the rest of the borrowings held by the federal government. Experts analyze the debt held by the public since this is the amount the government must repay.

«THE RECENT JUMP IN THE U.S. FISCAL DEFICIT WAS A COMBINATION OF A STEADY INCREASE IN FEDERAL GOVERNMENT SPENDING AND A PLUNGE IN FEDERAL GOVERNMENT RECEIPTS.»

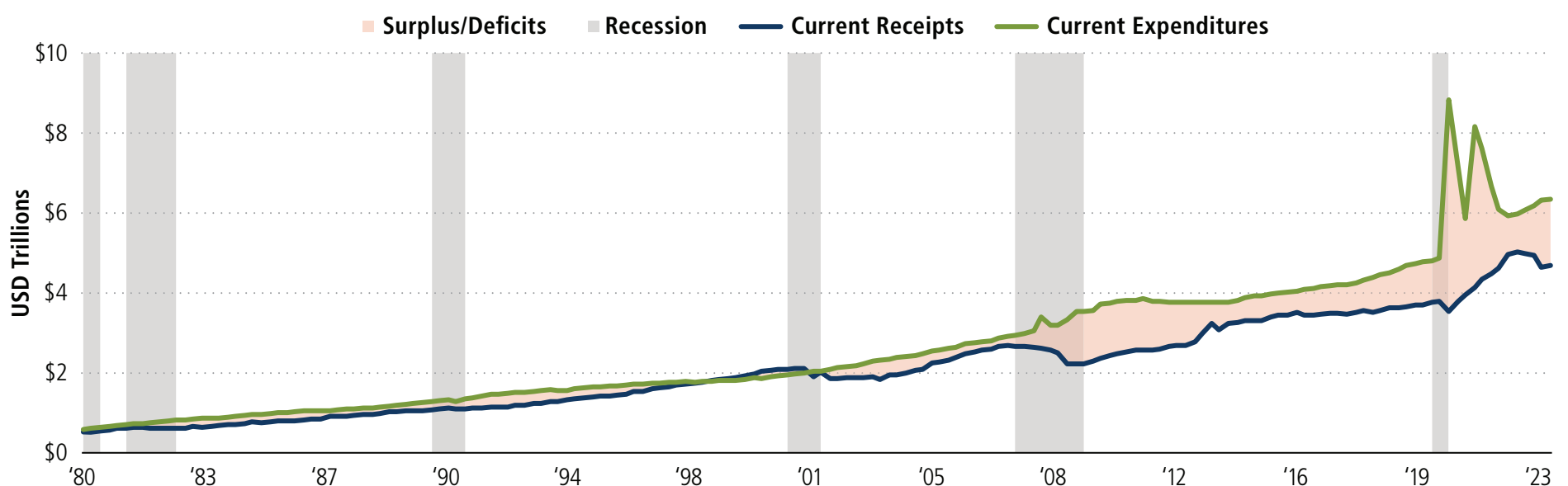
So, what drove the massive budget gap, and will 2023's fiscal woes become long-term problems? As with most macro matters, we find the worries overdone.

READY FOR A CLOSE-UP LOOK

The first step in understanding an unforeseen event is to piece together the clues about what happened. In the case currently under review, the recent jump in the U.S. fiscal deficit was a combination of a steady increase in federal government spending and a plunge in federal government receipts (see Figure 1).

fig 1. INCOME HITS THE BRAKES:

FEDERAL GOVERNMENT CURRENT RECEIPTS AND EXPENDITURES



Source: Bureau of Economic Analysis

fig 2. FINE TUNING THE ACCOUNTING:

ADJUSTED FEDERAL GOVERNMENT CURRENT EXPENDITURES AND CURRENT RECEIPTS DETAILS, USD BILLIONS

Let's examine the revenue side first. Federal revenue dipped by \$457 billion in fiscal 2023. So, contrary to the recent news headlines that often label the budget problem as an "overspending" issue, a sharp reduction in tax receipts explains much of the surprise increase in the total deficit in 2023.

«THE MARKET VALUE OF HOUSEHOLD EQUITY HOLDINGS DIPPED BY 25% YEAR-OVER-YEAR IN LATE 2022, CONTRIBUTING TO AN 8% DECREASE IN TOTAL PERSONAL TAXES COLLECTED IN 2023.»

Compared to a high-revenue 2022 fiscal year, the plunge in government receipts in 2023 was likely a temporary shock. Notably, individual income tax payments, the government's primary source of revenue, dipped by \$456 billion. Why the drop in individual taxes amid a robust labor market? The answer is simple: capital gains tax payments plunged in 2023 as a lagged result of the stock market plunge in 2022. The market value of household equity holdings dipped by 25% year-over-year in late 2022,³ contributing to an 8% decrease in total personal taxes collected in 2023.⁴

In addition, due to tax deferral policies for residents in disaster areas, such as areas affected by wildfires in California, part of the federal revenue collection from fiscal 2023 was also pushed to 2024.

Finally, the miscellaneous "other taxes" category from Figure 2 decreased by \$127 billion in 2023. "Other taxes" include revenues collected from other sources like import duties and, most importantly, excess earnings from the Federal Reserve.

The Fed borrows short and lends long—meaning it pays the federal funds rate on its liabilities while earning income from its portfolio of assets. If you're paying out 5.5% but only earning 1.00% (say, on 10-year Treasury notes purchased in 2020), it's no surprise when your profits are squeezed. The Congressional Budget Office (CBO) estimates that profits from the Fed decreased to \$500 million in fiscal 2023 from \$107 billion in 2022, accounting for much of the reduction in the "other taxes" category.⁵ Since rates will likely remain high in 2024, fed earnings might continue to drag down overall federal revenue.

But there is a silver lining: Stock markets have rallied in 2023, and additional revenue collection will fatten coffers in fiscal 2024. So, income tax revenue should return next year, reversing the temporary shock during 2022 and 2023.

SPEND IT FASTER THAN YOU MAKE IT

On the spending side of the budget deficit equation, total government expenditures increased by \$552 billion from fiscal 2022 to 2023 (see Figure 2)!⁶

	FISCAL 2022	FISCAL 2023	CHANGE FROM 2022
Total Revenue	4,896	4,439	-457
Individual Income Taxes	2,632	2,176	-456
Corporate Income Taxes	425	420	-5
Social Insurance and Retirement Receipts	1,484	1,614	131
Other Taxes	356	229	-127
Total Spending	5,892	6,444	552
National Defense	767	821	54
Education (Adjusted)	260 (-379)	292 (+333)	32
Medicare	755	848	92
Income and Social Security	2,084	2,129	45
Net Interest	475	659	184
Other Discretionary Spending	468	627	159
Other Nondiscretionary Spending	1,083	1,068	-14
Total Deficit	-995	-2,004	1,009
Debt Held By Public	24,244	26,248	2,004
Nominal GDP	25,020	27,624	2,604
Total Deficit As A % of GDP	4%	7%	3%

Source: U.S. Treasury, CBO

«WITH SENIORS PROJECTED TO REACH 20% OF THE TOTAL POPULATION BY 2030, HEALTHCARE AND RETIREMENT BENEFITS WILL CONTINUE TO BOOST GOVERNMENT SPENDING.»

All told, federal expenditures have grown at an average rate of 9% year-over-year since July 2022, well above the 6% average year-over-year growth from 2014 to 2019.

What does the federal government spend our money on? Overwhelmingly, the U.S. spends on "non-discretionary" items, namely pension plans (Social Security), unemployment and veteran benefits, and health care (Medicare), which comprise 66% of the spending in fiscal 2023. And, if we include our aircraft carriers ("defense spending") and interest payments on debt, we're up to 88% of total spending. So-called "other discretionary" spending accounts for the rest.

So, what is driving the increase in Social Security and healthcare spending in 2023? Part of it is higher interest rates and inflation, as retirement and unemployment benefit payouts are inflation-adjusted, and medical bills have become much more expensive. Higher prices

lead to higher inflation-adjusted payments. Price-driven spending pressures may ease when inflation (hopefully) subsides in a few years.

Nonetheless, an aging population explains the bulk of the growth in spending. In 2022, seniors accounted for 17.3% of the U.S. population, up from 13.7% in 2010.⁷ But, with seniors projected to reach 20% of the total population by 2030, healthcare and retirement benefits will continue to boost government spending.

«THE U.S. GOVERNMENT PAID \$659 BILLION OF NET INTEREST TO ITS TREASURY HOLDERS IN FISCAL YEAR 2023, 39% MORE THAN IN FISCAL YEAR 2022.»

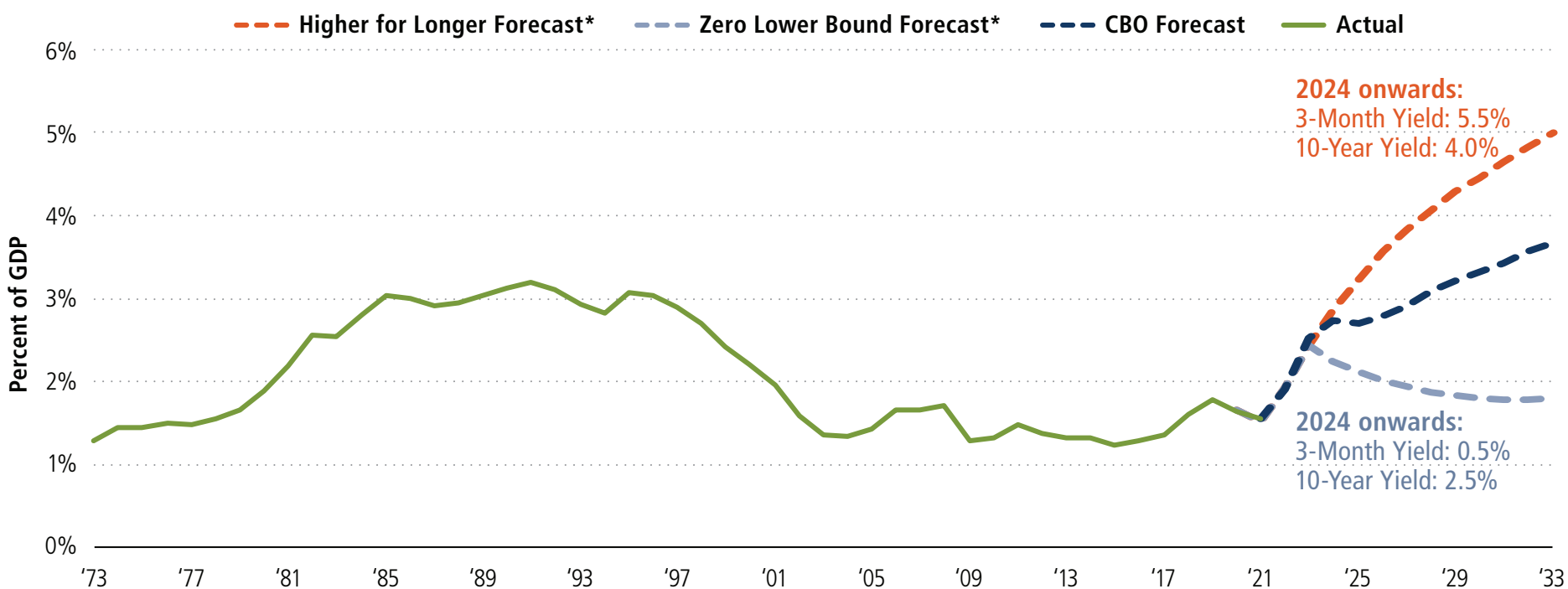
BORROWING MORE TO PAY BACK MONEY ALREADY OWED?

Another category is worth considering in detail because it paints a worrisome picture to deficit observers: interest paid on the federal debt. The U.S. government paid \$659 billion of net interest to its Treasury holders in fiscal year 2023, 39% more than in fiscal year 2022. The total amounts to 2.4% of nominal GDP.

While net interest expense as a share of GDP is still lower than the historical high of 3.1%

fig 3. HOW BAD COULD IT GET?

NET INTEREST OUTLAYS AS A SHARE OF GDP BASED ON VARIOUS INTEREST RATE PATHS



Source: CBO, Payden Calculations

*For simplicity, we are assuming CBO projections for total debt and nominal GDP are unchanged; 20% of U.S. debt matures every year and is refunded evenly between bills and 10-year notes.

in 1991, investors are anxious that the growing trend in interest payments might reach a tipping point. Pessimists worry that total debt might become unsustainable unless the government cuts spending elsewhere. Why might a high net interest payment be especially alarming for bond investors? Because it could trigger a vicious debt cycle. As net interest payments increase, the Treasury must issue *more* debt to finance expenditures, leading to higher yields and interest payments. It's like borrowing more at a higher rate to pay off your credit card—the debt snowballs.

CRYSTAL BALL BUDGET GAZING

The budget concerns above may sound far-fetched, but when net interest payment reached just 3.1% of GDP in 1991, it sparked a budget crisis and fueled Newt Gingrich's "Contract with America." The plan cut spending by slashing welfare programs. Consequently, the federal budget "broke even" from 1998 to 2000, creating a surplus in 2001.⁸

Will a similar budget-busting episode occur once the interest payment breaches 3.1% of GDP? Instead of offering a specific, calculated path of interest payments, we outline a range of possibilities.

«ACCORDING TO THE CBO'S BASELINE PROJECTIONS, NET INTEREST PAYMENTS WILL REMAIN A MANAGEABLE SHARE OF GOVERNMENT SPENDING, PROJECTED TO INCREASE FROM 2.5% TO 3.3% OF GDP BY 2030.»

According to the CBO's baseline projections, net interest payments will remain a manageable share of government spending, projected to increase from 2.5% to 3.3% of GDP by 2030. Alternately, net interest payments could return to 1% of

GDP if interest rates quickly return to the zero lower bound, which is unlikely unless the U.S. experiences a deep recession.

However, in the worst-case scenario, in which interest rates linger at high rates for ten more years, net interest payments could reach 5% by 2033 (See Figure 3)! In this case, slashing spending may become more urgent.

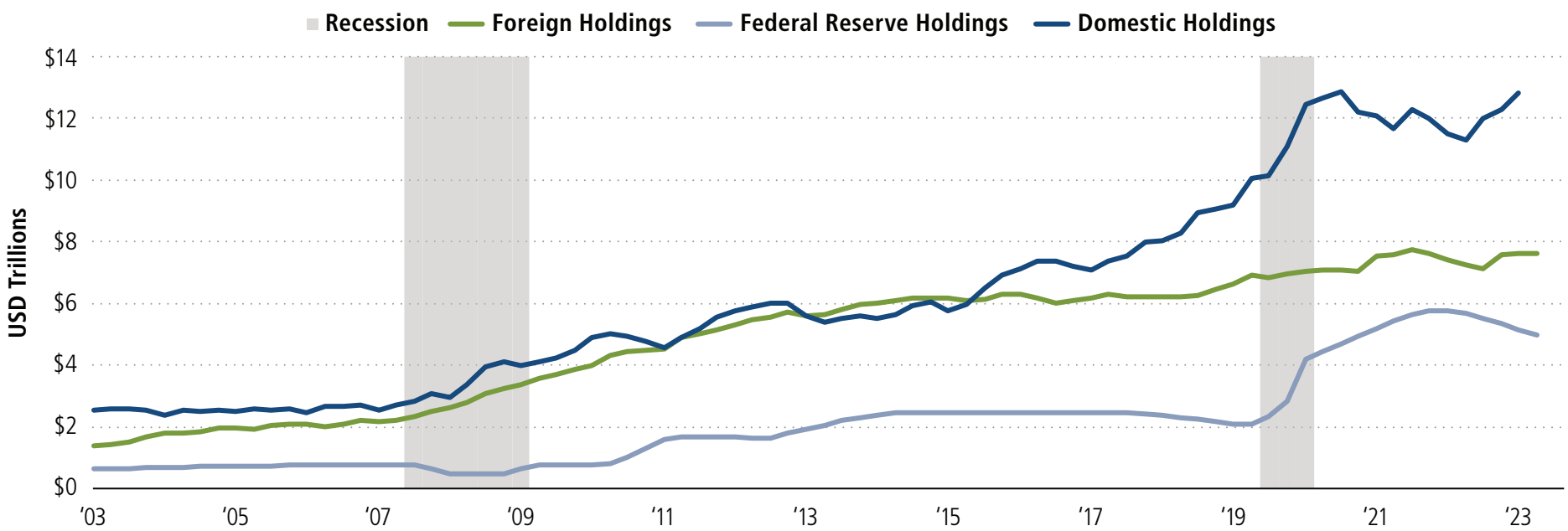
LET'S PROBLEM SOLVE

At this stage, some readers may wonder how a nation spends \$2 trillion more than it brings in. The answer is borrowing. Excluding 2020 (i.e., during the height of the Covid-19 pandemic), the total Treasury issuance in 2023, including the announced issuance in Q4, amounts to \$2.54 trillion—the most significant year since 2000. Meanwhile, another \$2.5 trillion in issuance is likely coming down the pipeline in 2024.⁹

The good news (for now) is that investors have enthusiastically gobbled up Treasury issuance

fig 4. STILL A TOP PICK:

U.S. TREASURY HOLDINGS OF DOMESTIC HOLDERS, FOREIGN HOLDERS, & FEDERAL RESERVE



Source: U.S. Treasury, Federal Reserve

(albeit demanding higher yields). In particular, Treasury bills, which have less than a year to maturity, accounted for 88% of net issuance year-to-date for the 2023 calendar year.¹⁰ Fortunately, investors from U.S. households to global corporations increased their Treasury purchases to “top up” Treasury coffers (See Figure 4 on page 6).


«SOME READERS MAY WONDER HOW A NATION SPENDS \$2 TRILLION MORE THAN IT BRINGS IN.»

BUT WHAT WILL HAPPEN IN TEN YEARS?

Let’s take a deep breath and review. The U.S. fiscal deficit is enormous. But, unlike other debt-burdened countries like Zambia that have recently defaulted due to rising debt service costs (See *Did You Know Box*), the U.S. remains the global reserve currency. And, if federal revenues rebound in 2024, the budget gap may narrow. Further, concerns about the net interest burden may be misplaced, as national resources (GDP) devoted to debt service remain below levels seen in the 1990s.

«CONCERNS ABOUT THE NET INTEREST BURDEN MAY BE MISPLACED, AS NATIONAL RESOURCES (GDP) DEVOTED TO DEBT SERVICE REMAIN BELOW LEVELS SEEN IN THE 1990S.»

The proper answer to the “What will happen in ten years?” question is that the ripple effects are more complicated to pin down in the long run. But in simple terms, no one holds the key to the future. Nevertheless, we wanted to provide another perspective amid cynical headlines.

In the meantime, the Treasury has a solution to the fiscal deficit, and investors seem to have an appetite for it. 

DID YOU KNOW?

ZAMBIA WAS DOWN THIS RABBIT HOLE

Take the case of Zambia’s default in 2020.¹¹ Zambia undertook extensive expansionary fiscal policies beginning in 2011. Over the following decade, Zambia continued to issue debt to finance its debt service and ever-growing deficit, amplifying the interest burden for the next year. Additionally, markets, losing confidence due to the high debt supply, demanded ever-higher yields, driving interest expenses continually higher. As this vicious cycle caused net interest payments to balloon, Zambia reduced non-discretionary spending in health, education, and other public services to finance its debt. Consequently, total debt stock reached 118% of GDP, and debt services costs rose to almost 30% of total expenditures in 2020, ultimately causing the nation to default on a \$42.2 million coupon payment. Despite being a more extreme case from an emerging market country, we can extrapolate the potential ripple effects from high sovereign debt issuance.

ENDNOTES

1. After student loan adjustment.
2. Moody’s Corporation (November 10, 2023). *Rating Action: Moody’s changes outlook on United States’ ratings to negative, affirms Aaa rating.*
3. The Federal Reserve (September 8, 2023). *Z.1 Financial Accounts of the United States.*
4. U.S. Bureau of Economic Analysis (November 29, 2023), *Gross Domestic Product (Second Estimate) Third Quarter 2023.*
5. Congressional Budget Office (September 2023), *September 2023 Monthly Budget Review.*
6. In 2022, the budget recorded an expense of \$379 billion from the proposed student loan forgiveness plan. In 2023, the Supreme Court struck down the plan, and the budget reduced education expenses by \$333 billion. For more details, see the September 2023 Monthly Budget Review from the Congressional Budget Office.
7. Statista Research Department (October 10, 2023), *Share of old age population (65 years and older) in the total U.S. population from 1950 to 2050.*
8. Winston, David (December 13, 2023), *The contract with America’s legacy.* Roll Call. <https://rollcall.com/2019/09/25/the-contract-with-americas-legacy/>
9. Office of Debt Management, U.S. Department of Treasury (November 1, 2023), *Fiscal Year 2023 Q4 Report.*
10. Securities Industry and Financial Markets Association (November 8, 2023), *U.S. Treasury Securities Statistics.*
11. Kessler, Martin (2023). *The Road To Zambia’s 2020 Sovereign Default.* Zambia Institute for Policy Analysis & Research. https://findevlab.org/wp-content/uploads/2023/03/Summary_Zambia_Debt_ZIPAR_17_03-1.pdf

This is a marketing communication. It is directed exclusively at professional investors or eligible parties and counterparties as defined by the rules of the Financial Conduct Authority or, for EU jurisdictions, by the rules of the Markets in Financial Instruments Directive (“MiFID”), as transposed in the relevant EU jurisdictions, and is not intended for use by retail investors. Suitability/appropriateness of the investment is the responsibility of the investor, no assurance can be given that any stated investment objectives will be achieved, and the value of investments may fall as well as rise. This information does not constitute an invitation or offer to subscribe for or purchase any products mentioned which will only be accepted on the basis of the relevant prospectus. Past performance is no indication of current or future performance, and that it does not take account of the commissions and costs incurred on the issue and redemption of shares.

This material reflects the firm’s current opinion and is subject to change without notice. Sources for the material contained herein are deemed reliable but cannot be guaranteed. This material is for illustrative purposes only and does not constitute investment advice or an offer to sell or buy any security. This material has been approved by Payden & Rygel Global Limited, an investment firm authorised and regulated by the Financial Conduct Authority of the United Kingdom, and by Payden Global SIM S.p.A., an investment firm authorised and regulated by Italy’s CONSOB.