US Macroeconomics

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Fiscal Recklessness

Earlier this week, the Administration released its fiscal year 2025 budget alongside Office of Management and Budget (OMB) scoring. Revenues as a share of GDP are projected to reach unprecedented levels but, because spending as a share of GDP is set to rise even faster, budget deficits are expected to be historically high.

Revenues as a share of GDP are forecasted at 18.0% for 2024, which is the highest reading since 2001 excluding the covid-related bounce back in 2021. Incredibly, they are also projected to rise as a share of GDP over the next 10 years, averaging more than 20% over the back half of the decade. Only once in the post-WWII era have revenues as a share of GDP hit 20%. That happened in 2000 when the stock market bubble pushed capital gains tax collection to a record high.

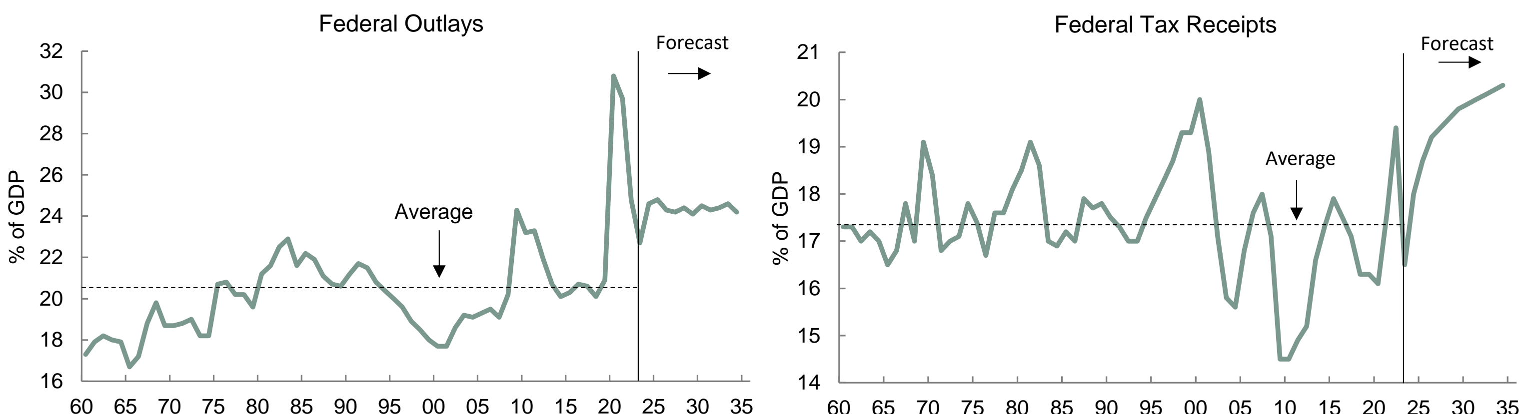
For the economy to produce such record revenues, tax rates would have to rise markedly. This in turn would almost assuredly collapse demand to such an extent that the projected revenue gains would never materialize. Remember that long-term budget forecasts assume steady state growth and no recession.

On the spending side, federal outlays as a share of GDP are predicted to rise to over 24% this year and then stay around those levels for the next 10 years. The economy has never experienced this level of spending on a sustained basis. Only in 2009 and during the pandemic did the spending share rise to 24% or higher. It quickly fell thereafter.

The current revenue and spending assumptions produce an estimated 6.6% budget deficit as a share of GDP this year, which then falls back toward 6% next year and then 5% in 2026. **The deficit is forecasted to average slightly more than 4% over the second half of the next decade which is unprecedented**. Of course, if there is a recession sometime in the next 10 years, which is almost a certainty, the budget deficit would likely rise by a minimum of three to four percentage points.

This is why the government's current financial state is so troubling. The economy is running record sized budget deficits alongside ultra-low unemployment. When the economy inevitably stumbles, the budget situation will rapidly deteriorate. Treasury supply concerns could resurface later this year.

For now, the bond market is not perturbed by record budget deficits and Treasury financing needs. But this could be due to, at least partly, by the Treasury's decision to frontload its financing. **Over the last 12 months, 77% of all marketable debt issuance was in bills or inside a one-year maturity**. What happens when the Treasury inevitably boosts its coupon supply? Will term premium rise, pushing long rates higher, or will the Fed reenter the equation as the buyer of last resort?



Source: Treasury, OMB, Haver, SMBC Nikko

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