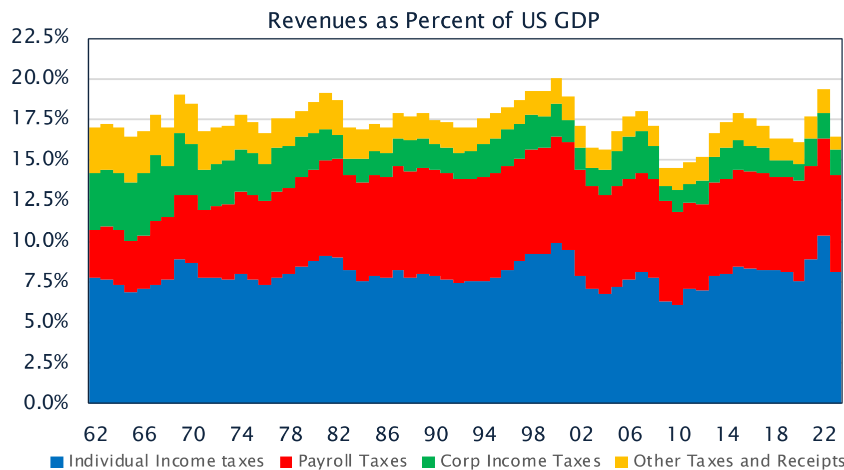
INVESTMENT UPDATE

Last month we wrote about global demographics and how aging populations around the world are likely to place significant additional burdens on the finances of governments in the years ahead. This month we'll take a closer look at how these and other factors are likely to impact the US fiscal balance, based on the most recent long-term outlook published by the Congressional Budget Office (CBO).

The CBO's 2024 projections include some changes from last year's report. The good news is that, due to Congressionally-mandated limits on discretionary spending, the long-term projections for both the federal budget deficit and the total amount of federal debt are a little lower this year than in last year's projections (down 1.6% and 17%, respectively, as a percent of US GDP). But that's where the good news ends. On the one hand, the longer term projections of GDP growth were boosted due to the positive impact of increased immigration benefitting the labor force. But the increase in immigration is expected to be more than offset by the negative impact of lower projected birth rates, where the trends have deteriorated over the past year. As a result, the population and work force projections were revised lower compared to last year, which will lead to a slower projected pace of economic activity and, thus, a dimmer outlook for tax revenues in the coming decades.

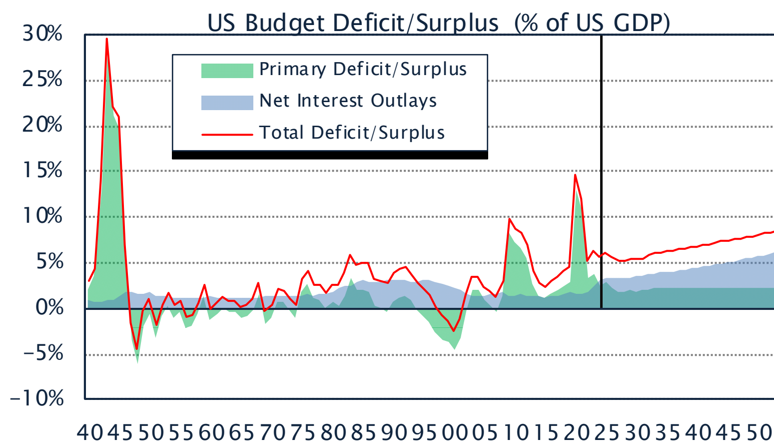


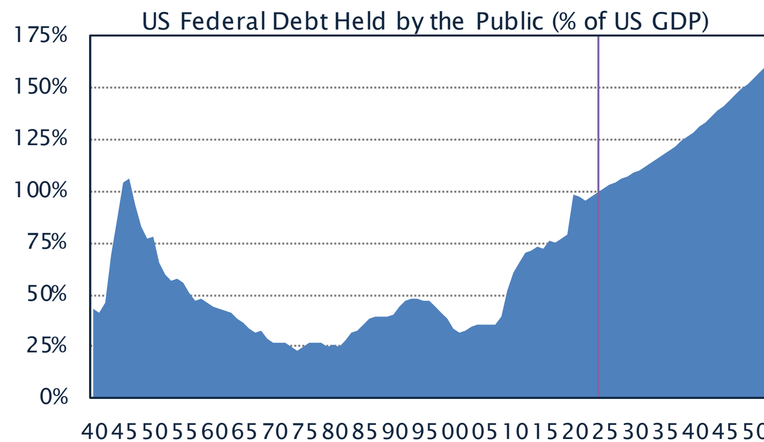
While we're on the subject of revenues, it might be helpful to look at recent trends. The chart on this page shows the main sources of US Treasury revenues as a percentage of US GDP (which helps put it in the context of the output of the US economy). Revenues are broken out into their main sources: personal taxes, payroll taxes, corporate taxes, and other taxes and receipts (which includes estate and gift taxes, excise taxes, customs duties, and other receipts). Currently, we are taking in approximately 16% of US GDP in the form of taxes and other receipts, which is towards the bottom of its recent range. You'll notice that revenues are somewhat cyclical, as tax revenues fall when the economy sputters as rising unemployment takes a bite out of personal income taxes.

But cyclicality alone isn't responsible for the variability of receipts and the mix of revenues; changes in tax policies have also led to swings in tax receipts. In 1982 Ronald Reagan's administration cut tax rates for businesses and individuals, resulting in a decline in revenues for the next few years. Alternatively, increases in tax rates by the GHW Bush and Clinton administrations led to increases in tax receipts. In fact, it was during the Clinton administration that the US last posted a budget surplus, as revenues grew to 20% of US GDP in the late 1990s (increased capital gains taxes on high flying dot-com stocks didn't hurt, either). Since the turn of the century, we've seen cuts in personal and corporate tax rates, and lower average revenues relative to the overall economy. To be clear, over the past 20+ years the US has also faced some pretty serious tax-generating headwinds, with terrorist attacks, a global financial crisis, and a worldwide pandemic hitting the employment (and thus, revenue) side of the equation. The combination of lower tax rates and two sizable economic recessions has reduced the average revenue the US has been collecting by about 1.5% of GDP, compared to what we were bringing in during the previous two decades.

Now, 1.5% might not sound like a lot, but that translates into approximately $375 billion annually in current dollars. During this same 20+ year period, as tax revenues have been shrinking relative to economic growth, spending has been growing as a share of GDP. Since 2003, tax receipts have grown by just 2.0% per year, while "on budget" spending (which doesn't include the impact of the Social Security program) has grown by 3.1%. Again, it doesn't sound like a big gap, but when compounded over 20 years, it means that the accumulated debt held by the public—the amount of money the Treasury has borrowed to bridge the funding gap—has grown from roughly $4 trillion in 2003 to $26 trillion in 2023, an annual growth rate of more than 9%.

The top chart on this page shows the net result of the swings in revenues and outlays since 1940, along with the CBO's latest projections out to 2054, with the red line representing annual deficits (or in the case of negative values, surpluses) in the US fiscal balance. There's not a lot of good news in these numbers, with projected annual deficits of at least 5% per year for the foreseeable future. A deficit of more than 5% has typically been associated with crisis periods in the past (e.g., World War II and the aforementioned crises of the past 25 years), but it now appears that 5% deficits are to be taken as a baseline for future negotiations. What's worse, these projections include some assumptions that tilt the numbers favorably. One example is the assumption that popular personal tax cuts and incentives passed in 2018 are set to expire in 2025 will do so, despite the widespread belief that Congress will pass enabling legislation before then to keep these lower rates on the books. In other words, the "real world" forecast for the US budget situation may well be even worse than the CBO's official projections.





Given that deficits are projected to grow in the coming decades, the accumulated national debt will therefore continue to increase, as shown in the bottom chart. Federal debt held by the public stands at approximately 97% of current GDP, but with the Treasury having to issue more and more debt to cover growing shortfalls, we will soon hit historic highs for this series, topping the previous high water mark that occurred in 1945 at the end of the Second World War. By the middle of this century, US federal debt is projected to exceed 150% of US annual GDP.

An additional reason for concern (in case you haven't heard enough) is that the growing level of indebtedness the US finds itself facing will also lead to growing interest costs for the US Treasury, which, in turn, will need to be borrowed as well. This "interest on interest" component of deficit spending currently accounts for around 3% of US GDP, but is projected to double, to more than 6% of GDP, by 2050. This is money that could go to defense, infrastructure, or social programs, but instead will go to investors who buy Treasury bonds. Keep in mind that these payments are highly sensitive to changes in interest rates over the coming decades; if interest rates drop, the debt service burden will ease somewhat; the opposite is true if rates rise in the future.

So, all told, we're looking at growing budget deficits for the next few years (if not decades), although the path won't be as linear as the CBO projections might imply; the business and credit cycles, after all, have not been repealed. As for solutions, there really are no easy choices, and real progress will not occur by taking a single-sided approach to solving our budget issues. The simple fact of the matter is that spending is too high and revenues are too low. There's no use in going after one or the other, fixes to both sides of the equation need to be explored.

Unfortunately, the political environment is so fractious that finding solutions seems like an impossibility right now. We need open dialog to collectively decide, as a nation, how we can support the citizens and infrastructure of our country while paying for it in a way that doesn't cripple growth or place an undue burden on households and businesses. As a country, we should be running surpluses during economic expansions so that we can cover the increased costs of stimulating the economy during recessions. This should not be controversial.

There are legitimate pathways to controlling our fiscal imbalances; we just need the resolve to address the issue. We'd start by looking to the seven-member coalition assembled by the Peterson Foundation, which includes the American Enterprise Institute, the Manhattan Institute, and the Progressive Policy Institute. These are credible organizations with the expertise to help guide lawmakers. It's time to get started.

This month, we're very pleased to be celebrating the 25th anniversary of Agincourt Capital Management's inception, a milestone that would not be possible without the trust of our clients. We sincerely appreciate your support, and look forward to continuing to serve you over the next 25 years.