U.S. Budget: How Is Spending Trending?
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by Milton Ezrati
of Lord Abbett

With the country set to elect a new Congress in just a few weeks and the 2016 presidential contest already in the news, this space aims, as a kind of public service, to look at who in the country pays for all Washington does and where Washington spends those funds. Perhaps the analysis will help readers, whether financial advisors or investors, pierce the fog and misinformation that inevitably accompanies election campaigns. To make what is a tsunami of data more digestible, this effort will come in two parts. This first number will take up spending, what Washington prefers to call outlays. It will show that without entitlements reform, virtually all the promises likely in the campaigns will be financially dubious. Next week’s discussion will look at the revenue side of the budget to see who supports the structure.

Overview

According to the president’s most recent budget, overall federal spending is scheduled to rise 5.3% a year between fiscal 2014 and fiscal 2019. This is slightly faster than the 5.1% rate the White House expects for growth in the nominal gross domestic product (GDP). Accordingly, the White House estimates a modest rise in what the government takes from the economy. Federal spending, according to these estimates, will rise from 21.1% of GDP presently to 21.3% by the end of this period.

Chances are that the government will end up taking a bigger share of the economy when all is said and done. There are at least two reasons. First, the White House’s economic growth projections lean toward the optimistic side. The administration expects real growth of 3.1% a year on average over these five years—a figure that exceeds the trends witnessed thus far in this recovery. Though an economic acceleration is possible, present signs hardly make it look likely. Nor do these projections admit to a recession, implying an unprecedented and unlikely recession-free 10-year stretch from 2009, when this recovery began, to 2019, the end date of the forecast period. Second, much of the projected budget savings comes out of defense (more on this below). With the fighting now in the Middle East as well as tensions with Russia, those cuts may not occur, and surely will fail to go as deep as the White House budget implies.

However much faster than GDP federal spending grows, the trend certainly fits with history. For more than 65 years now, government outlays have outpaced nominal GDP through both Republican and Democratic administrations and Congresses. They rose from 11.3% of GDP in 1948 to 20.6% in 1998, gaining on average slightly more than 0.2 percentage points of GDP a year throughout this time. The pattern broke briefly at the turn of the century, when the so-called “peace dividend” that came with the
end of the Cold War slowed the pace of overall federal outlays below that of the overall economy and Washington’s spending fell three full percentage points of GDP, to 17.6% by 2001. Thereafter, the old pace of relative expansion resumed, in response to the continued expansion of the welfare state plus the Iraq and Afghan wars. Under both President Bush and President Obama, spending gained share of GDP by just about the historical pace of 0.2 percentage points a year. Applying this well-established trend to coming years would take federal spending up to a level more like 22.1% of GDP by 2019, well above the White House projection of 21.3%.

The Big Pieces—Defense and Entitlements—Combined Are Almost 90% of All Outlays
As already indicated, the White House expects savings from defense-spending cuts. It projects a 3.0% drop in Pentagon outlays each year between now and 2019. That would take the defense allocation from its current level of 3.6% of GDP (20.1% of the budget) to 2.6% of the GDP (16.2% of the budget) by 2019.

Even before the recent trouble in the Middle East and Ukraine, this was an ambitious goal. To be sure, defense spending has trended down relatively for a long time. In the 1950s, even removing the effects of the Korean War, spending by the Pentagon averaged almost 10% of GDP and amounted to more than half of government spending. From the 1960s through the 1980s, it averaged more than 6.0% of GDP and about one-third of all federal spending. By the end of that decade, it was running about 4.5–5.0% of GDP. It did fall briefly below 3.0% of GDP between 1999 and 2001 because of the Cold War peace dividend, but picked right up again with the “War on Terror.” Even then, it came nowhere near earlier levels. For all the fuss made over the costs of war in Iraq and Afghanistan, defense outlays rose to a high of only 3.8% of GDP during that time and remained an historically small 20.1% of the budget. But even in the face of this gradual downtrend, it stretches credulity to expect the projected budgeted declines. Both past norms and geopolitical pressures conservatively point to spending about 0.5 percentage points of GDP higher than the White House projects in its budget, bringing it closer to 3.1% of GDP than the official 2.6% projection for 2019.

White House expectations on entitlements spending are even less consistent with historical trends than are its expectations on defense. This broad category includes outlays on Social Security, Medicare, Medicaid, unemployment insurance, an array of smaller programs, and, looking forward, outlays required by the Affordable Care Act. Throughout this long history, spending on these items consistently has outpaced both the rest of the budget and the growth of GDP. At the end of World War II, for example, entitlements obligations about equaled defense spending, amounting to 3.4% of GDP and about 30.4% of the budget. By 1975, they had risen to almost 10.0% of GDP and almost half of all federal outlays—almost twice defense spending at the time. By the end of the century, such outlays were three times the size of the defense budget, amounting to about 60% of all federal spending and almost 11% of GDP. Even as the Iraq War shifted budget priorities, entitlements spending continued to rise faster than the economy, so that they now account for about 70% of all federal spending and just less than 15% of GDP—more than four times defense spending. In contradiction to these powerful trends, the White House projects little further relative growth to 2019—a dubiously optimistic outlook given this history and certainly anticipating the outlays connected to the Affordable Care Act.

Interest
On both these important counts, then, the White House spending estimates look low. Since combined defense and entitlements amount to almost 90% of all federal spending, their patterns effectively say it
all for overall spending, which, given these observations, will likely end up absorbing two-plus percentage points more GDP than the White House suggests. On this basis, the economic burden of the federal government by 2019 would easily approach the high of 24.4% of GDP recorded during the 2009 economic emergency. But there is another element in the equation that might push up the figure even higher, and that is interest expense on the outstanding debt.

In recent decades, interest expenses have tended to rise relentlessly because chronic deficits have added, equally relentlessly, to outstanding debt loads. Up until the late 1970s, however, manageable deficits and contained rises in interest rates kept these expenses from rising too much faster than GDP. In 1976, for instance, interest expenses amounted to only 1.5% of GDP and 7.2% of all federal spending. But by the early 1980s, expanding deficits and a spike in interest rates raised interest expenses briefly to more than 3.0% of GDP, and brought them up to fully 14.0% of all federal spending at the time. In the 1990s and earlier in this century, falling interest rates and more moderate deficits allowed this relative expense to fall toward 1.7% of GDP by 2007. Despite huge deficits since then, very low interest rates have actually pushed down this expense item. In 2014, outlays for interest will likely amount to only 0.8% of GDP (6.1% of all federal spending.) Looking forward, however, it is apparent that this relief cannot last. Deficits, though reduced from a few years ago, remain historically large, and rates, if the Federal Reserve is to be believed, are scheduled to rise.

Anticipating this effect, the White House’s interest-rate projections are not unreasonable. The president’s budget assumes that 91-day Treasury bill rates will rise from about zero today to 1.2% on average in 2016 and 3.6% by 2019. It projects that 10-year Treasury note yields will rise 140 basis points from present levels, to 4.0% by 2016 and another 70 basis points to 4.7% in 2019. These increases push projected interest expenses from 1.7 percentage points of GDP to 2.5% by 2019 (11.6% of all federal outlays.) Of course, if other considerations—on defense and entitlements—turn out anywhere near accurate, deficits also will rise higher than the president’s budget projections, raising interest expenses more than expected in the budget, even if the White House has made an accurate interest rate forecast. On this basis, the expense from interest will likely rise to approach the 3.0% it averaged in the 1990s. Adding this difference into the mix should easily bring the overall economic burden of the federal government above the 2009 record of 24.4%.

A Qualitative Conclusion

For all the number crunching, either here or by the White House, it bears saying that such figuring is always slippery, especially five years out. But if the exercise cannot bear the precision people would like, there are at least three inescapable conclusions to draw from this work:

1) Unless Washington turns away from more than 60 years of precedent and engages in entitlements reform, the relentless demands of these programs, already more than 70% of the entire budget, will burden the economy increasingly and dominate the budget still more going forward, squeezing out other government priorities.

2) At one time, defense spending was large enough so that cuts there could offset the overall effect of the ever-growing entitlements expense. Because the Pentagon has fallen as a portion of the budget, savings there no longer offer the leverage on overall spending they once did, even if cuts were feasible, which, with the growth of global tensions, they are not.
3) With the inevitable rise in interest expense on top of these effects, Washington will lose almost all flexibility with the rest of the budget. The programs that the election campaigns will describe and promise will be a chimera, in particular the plans for infrastructure refurbishing and research and development that make a regular return to prominence with each election cycle.

1 All data from the Budget of the United States 2015

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