



It's the Domestic Spending; Stupid

Washington DC is out of control. In Orwellian Newspeak, we hear liberals say tax cuts, “cost too much,” but deficit spending is an “investment.” If GOP politicians reduce spending growth from already inflated forecasts, they call it a “‘conservative’ spending cut.” And, politicians from both sides of the aisle pat themselves on the back for “working so hard” to reduce the deficit when it’s really the US taxpayer that provided the muscle. Surging tax receipts have lowered deficits in recent years, not fiscal discipline.

Insanely complicated budgetary rules, which favor spending, have permanently kept the US in deficit since the early 2000s, and have seemingly made it impossible to ever balance the budget again in our lifetimes. The now infamous “London Whale” lost a few billion at a well-known bank, and that made headlines for months. But government inefficiency and fraud cost taxpayers billions every week and no one seems to care.

Every time a GOP presidential hopeful talks about tax cuts, the revenue neutral, and static, budget models come out of the woodwork to attack them as money losers. But, when spending goes higher and higher with each and every budget, it seems everyone forgets how to do simple math.

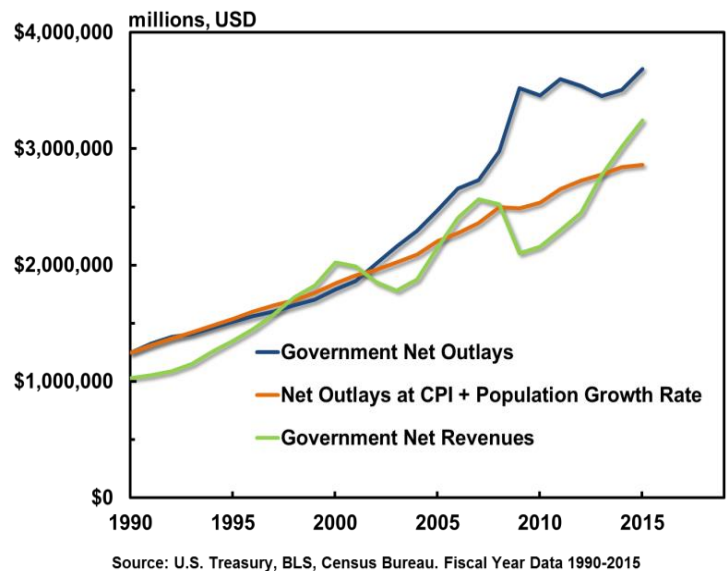
Many blame the Mideast wars for deficits, and the CBO estimates the cost was \$1.6 trillion dollars. But that’s only a small part of the story. Since 2000, non-defense government spending has been a total of \$6.3 trillion higher than it would have been if it had only increased by population growth plus inflation. In other words, for every dollar spent on the wars, the federal government increased domestic spending by \$4. Non-defense spending (primarily redistribution) has been the biggest cause of deficits.

Three charts tell the story. The first (to the right) shows total federal spending since 1990. For comparison, the chart also plots what spending levels would have been if the budget had only increased at population growth plus inflation – the spending level necessary to keep inflation-adjusted, per capita spending constant.

As the chart shows, under the final two years of Bush 41 and the eight years of the Clinton presidency,

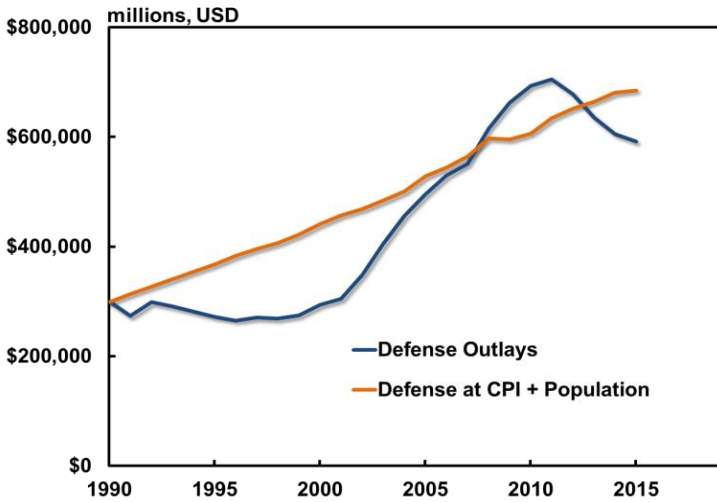
total government spending tracked right along with population growth plus inflation. But, under Bush 43 and President Obama, spending accelerated sharply.

Also shown on the chart is total federal tax receipts (the green line). If government spending had grown at a rate that kept real per-capita spending steady, the US would have had a \$384 billion dollar surplus in fiscal year 2015, rather than a \$439 billion dollar deficit.

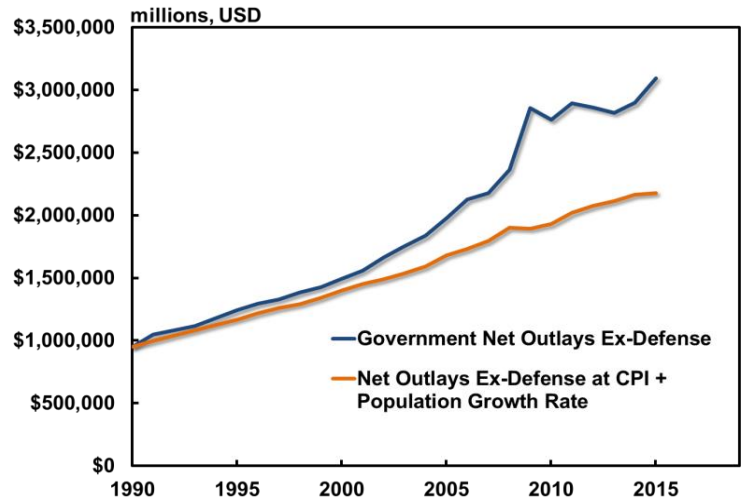


No matter how revealing those data are, they hide some important underlying trends. President Clinton held down spending by cutting defense (the so-called peace dividend). As can be seen in the chart below (upper left, page 2) defense spending fell sharply below the level necessary to keep it tracking with population growth and inflation during the 1990s, then shot up after 9/11 (with wars in Afghanistan and Iraq), but has now fallen sharply again under President Obama.

In fact, since 1990, total defense spending has been \$1.3 trillion less than it would have been if it had held steady on a real, per-capita basis. In other words, even with the wars in the Middle East, there has been a peace dividend. Unfortunately, the world has not cooperated and war with radical Islam has risen as the Cold War dissipated. It seems fair to argue that as US defense spending slowed, the world has become a less safe place.



Source: U.S. Treasury, BLS, Census Bureau. Fiscal Year Data 1990-2015



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As can be seen in the final chart (above, right), the real culprit behind current large deficits is non-defense government spending. This measures all entitlement spending, redistribution and the cost of government agencies.

Non-defense spending grew faster than population growth plus inflation from 1990 to 2000, but just slightly. Then, after 2000, it accelerated sharply even before the Panic of 2008. The trend was rising under President Clinton, but was offset by defense cuts. But, under President Bush both domestic and military spending grew and then under President Obama domestic spending stayed high.

In other words, the US is spending a significantly larger amount (nominally and on an inflation-adjusted basis) per person today than it did in either 1990 or 2000. Part of this was misguided bank bailouts under TARP, but as the chart clearly shows, even though TARP has been mostly paid back, government spending has not fallen back to previous levels. So, not only have we spent the peace dividend, we've spent it five times over, even with interest costs falling to historic lows. As a result, in spite of a surge in tax receipts the US is still facing significant deficits.

From a political perspective, while some of this happened under President Bush with the passage of Medicare Part D, No Child Left Behind and other government programs, the biggest surge in spending came after 2008, with the \$700 billion bailout of banks and auto companies.

We have said this many times in the past, but this "government to the rescue" philosophy has undermined the ability of politicians to push back on the size of government. If Republican's believe in big government, then who is left to fight against it? As a result, even though most of TARP has been paid back and the government has taken \$188 billion of profits out of Fannie Mae and Freddie Mac in the past three years (which count as negative spending), total government spending set a new all-time record high in fiscal year 2015.

The bottom-line is that it is not defense and war spending that drove the US into massive deficits, but domestic spending and entitlements. Unless the US gets those under control, deficits from this point forward will only get worse.