First Trust
Monday Morning OUTLOOK

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Fiscal Madness

Back in the 1980s, President Reagan took enormous political heat (Sam Donaldson comes to mind) for being fiscally irresponsible. His offense? Presiding over a budget deficit that peaked at 5.9% of GDP in Fiscal Year 1983.

But at least Reagan had an excuse. Actually, multiple excuses. The unemployment rate averaged 10.1% in FY 1983, which pushed up spending, while reducing revenue. The Reagan tax cuts were phased-in, so many people pushed off income (and taxes) into future years. Finally, the US decided to bury the USSR under massive defense spending.

The reason we bring this up is that we estimate the budget deficit for this year (FY 2023, ending September 30) will be $1.74 trillion, or 6.5% of GDP. That's larger relative to GDP than the largest budget deficit ever under Reagan. Worse, this is happening when the unemployment rate will average about 3.6%, the lowest average for any fiscal year in more than fifty years.

But the current budget situation is even worse than these numbers suggest. Last year (FY 2022), the budget deficit came in at $1.375 trillion. But this deficit was artificially boosted by government accounting. President Biden's plan to forgive student loans lifted the deficit by $379 billion, the present value of the extra future losses estimated on the forgiven debt. The government's budget accounting rules included it as extra spending last year, even though it didn't affect the government's cash flow.

In other words, without the Biden loan forgiveness plan, the budget deficit would have been about $996 billion last year, or 4.0% of GDP. Not good, but not horrible, either.

But this year the Supreme Court struck down most of the loan forgiveness plan. As a result, extra future loan repayments are now being added back into the budget. The government counts this as a "negative outlay," and this change results in a one-time artificial reduction in the deficit of $330 billion. Without the Supreme Court ruling we estimate the budget gap this year would be about $2.07 trillion, or about 7.8% of GDP.

These government accounting rules might make sense in normal times, but right now they are leading to a bizarre result that hides a massive increase in the "cash flow" deficit of the US government. The result is a much bigger change than the "official" numbers, which will show the budget deficit going from $1.375 trillion (5.5% of GDP) to $1.740 trillion (6.5% of GDP).

There is no economic justification for expanding the "cash flow" deficit by 3.8 percentage points of GDP (from 4.0% to 7.8%) unless there is a recession or World War III. We never had a budget deficit greater than 6.5% of GDP in *any* year from 1950 through 2008. Not one. Reasonable people can disagree about the size and scope of the budget deficits we should have run in the aftermath of the Great Recession as well as during COVID Lockdowns. But running a budget deficit this high right now is madness!

We are supply-siders. We think the key to long-term economic growth is removing barriers and disincentives to work, save, and invest. We do that with lower tax rates, smaller government, and less regulation. We think institutions matter, like democracy, property rights and freedom of contract. We are not Keynesians. But even John Maynard Keynes must be rolling over in his grave. No serious or intellectually honest Keynesian can support a deficit at 6.5% of GDP (much less 7.8%) in a year when the US is at peace and unemployment is averaging 3.6%.

And just so everyone knows, we are not attacking one party over the other. TARP, multiple rounds of quantitative easing, COVID lockdowns, unprecedented fiscal stimulus during COVID, and repeated failures by both parties to address entitlements have all paved the way to the current deficit bubble.

We realize the US had bigger deficits right after the Financial Crisis and during COVID, but given low unemployment and peacetime, we don't think we're overdoing it when we say that this year's budget is the most reckless and irresponsible in the history of the Republic.

We think that the unprecedented surge in the deficit this year is a key reason why a recession has yet to materialize. A surge in the deficit this large can sometimes artificially maintain growth in the very short-term. But, given higher interest rates on government debt, this kind of support can't last. The party continues for now, but a hangover looms in our future.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-5 / 9:00 am	Factory Orders – Jul	-2.5%	**-2.1%**	-2.1%	+2.3%
9-6 / 7:30 am	Int'l Trade Balance – Jul	-$68.0 Bil	**-$68.8 Bil**		-$65.5 Bil
9:00 am	ISM Non Mfg Index – Aug	52.5	**52.6**		52.7
9-7 / 7:30 am	Initial Claims – Sep 2	233K	**233K**		228K
9-8 / 7:30 am	Consumer Credit– Jul	$16.0 Bil	**$17.0 Bil**		$17.8 Bil