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U.S. Public Finances FY 2017

The deficit grows but the debt stabilizes, for now.

United States of America

Analysis Report — October 31, 2017

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HR Ratings comments on the results of fiscal year 2017 for U.S. government finances, which show an expanding deficit but a relatively small increase in publicly held debt.

During FY17 the primary deficit increased a substantial 16.22% in nominal USD while the overall financial imbalance expanded a smaller but still substantial 13.33%[1]. HR Ratings estimates that the deficit to trailing four-quarter GDP (LTM) reached 3.47% for FY17, a rise from FY16's 3.18% Notable is the substantial 9.16% increase in net interest expense. Based on HR Ratings calculation, the effective average cost[2] of the public debt advanced a relatively modest 8 basis points (bps) during the last fiscal year to 1.83%. This is a relatively moderate increase in the cost of the public debt, given our estimate of the approximately 40bps increase in the average monthly Federal Funds rate and, for example, the yield on the ten-year Treasury Note.

US Public Finances (US$ billions)	FY up to September		% Change
	sep-16	sep-17	
Total Receipts	**3,266.7**	**3,314.9**	**1.48%**
Individual Income Taxes	1,546.1	1,587.1	2.65%
Corporate Income Taxes	299.6	297.0	-0.84%
Payroll Taxes	1,115.1	1,161.9	4.20%
Other	306.0	268.8	-12.14%
Total Outlays	**3,854.1**	**3,980.6**	**3.28%**
Social Security	916.1	944.9	3.14%
Medicare	594.5	597.3	0.47%
Medicaid	368.3	374.7	1.74%
Defense	565.4	568.9	0.63%
Other	1,169.1	1,232.1	5.38%
Total Primary spending	3,613.4	3,717.8	2.89%
Net Interest*	240.7	262.8	9.16%
Primary Deficit	**-346.7**	**-402.9**	**16.22%**
Financial Deficit	**-587.4**	**-665.7**	**13.33%**
Deficit as % of LTM GDP	-3.18%	-3.47%	n.a.
Publicly Held Debt (end of period)	**14,173**	**14,673**	**3.53%**
Debt as % of LTM GDP	76.7%	76.5%	n.a.
Change in Debt during period	1,049.6	500.0	-52.36%
Average effective cost of debt (12MMA)	**1.75%**	**1.83%**	**n.a.**

Source: HR Ratings with information from the Treasury Department, CBO and BEA (for GDP data).
Fiscal Year 2017: from October 2016 to September 2017.
*Table 9 of the monthly Treasury Mts reports.

The increase in the deficit, particularly in the rise in interest expense, is particularly relevant in the context of the debate over tax policy and the expectation of rising interest rates. Also relevant, however, is the fact that despite the larger deficit, the increase in the public debt was substantially smaller. During FY17 public debt expanded by US$500bn, less than the

[1] The primary balance refers to total revenues less total expenditures excluding net interest costs. The financial balance does not exclude net interest costs.
[2] Defined as the LTM reported net interest cost divided by the average of the monthly closing public debt level for the same period.

US$666bn increase in the deficit. In contrast, during FY16 the smaller US$587bn deficit was reflected in a large US$1,050bn expansion in publicly held debt.

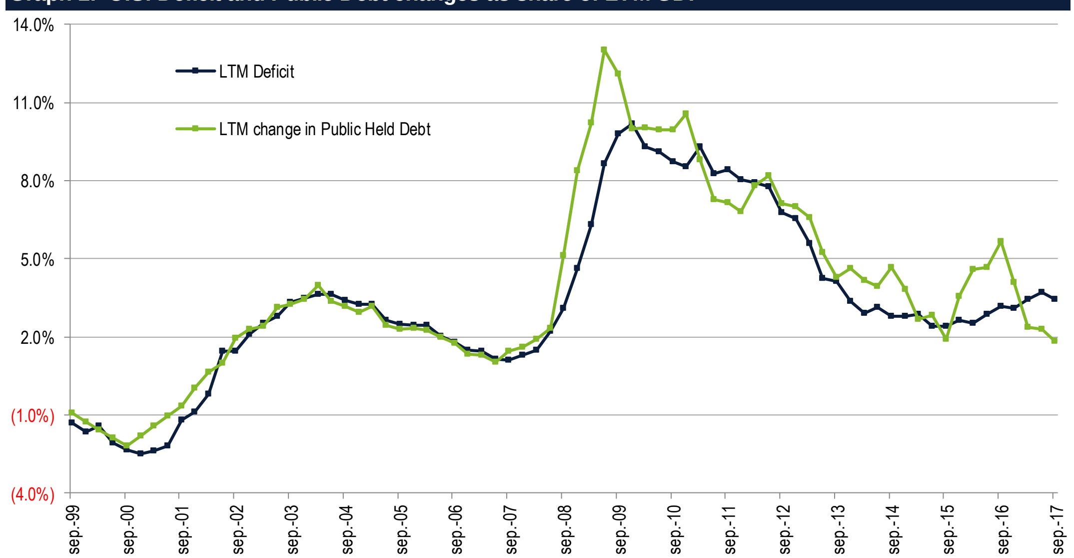
As a result, for those who believe that deficits and the debt do matter, the concern sparked by the rise in the FY17 deficit relative to GDP (3.47% vs. 3.18%), which follows a larger FY16 ratio vs. FY15 (2.43%), is partially ameliorated by the fact that public debt as a percentage of LTM GDP shows a slight decline (76.5% vs. 76.7%).

The trends, however, suggest that unless real economic growth rises to a higher sustained level, the deficit to GDP ratio may continue to rise. Even with the strong 3Q17 initial GDP numbers, LTM real GDP growth was still a modest 2.08%.

Total receipts for FY17 rose a modest 1.48% despite the nominal 3.83% increase in GDP for the same period. In contrast, totally outlays expanded at a stronger 3.28% with primary expenses advancing 2.89%, driven by non-defense "non-entitlement" spending (5.38%) and social security (3.14%). However, according to the CBO[3] timing shifts produced lower spending in certain accounts. Adjusting for these shifts, Medicare outlays rose by 3.9% while other spending would have advanced a still stronger 6.7%. This suggests that, absent offsetting factors, FY18 could show stronger total increases in spending.

The larger financial deficit of US$666bn represented 3.47% of trailing GDP, an increase from the 3.18% for the deficit for FY16. After declining from the substantial deficits experienced in the aftermath of the 2008 financial crisis the imbalances began once again to increase as of mid-2015. In Graph 1 it is shown the evolution of the 12-month moving average deficit as a percentage of LTM GDP.

Graph 1: U.S. Deficit and Public Debt changes as share of LTM GDP



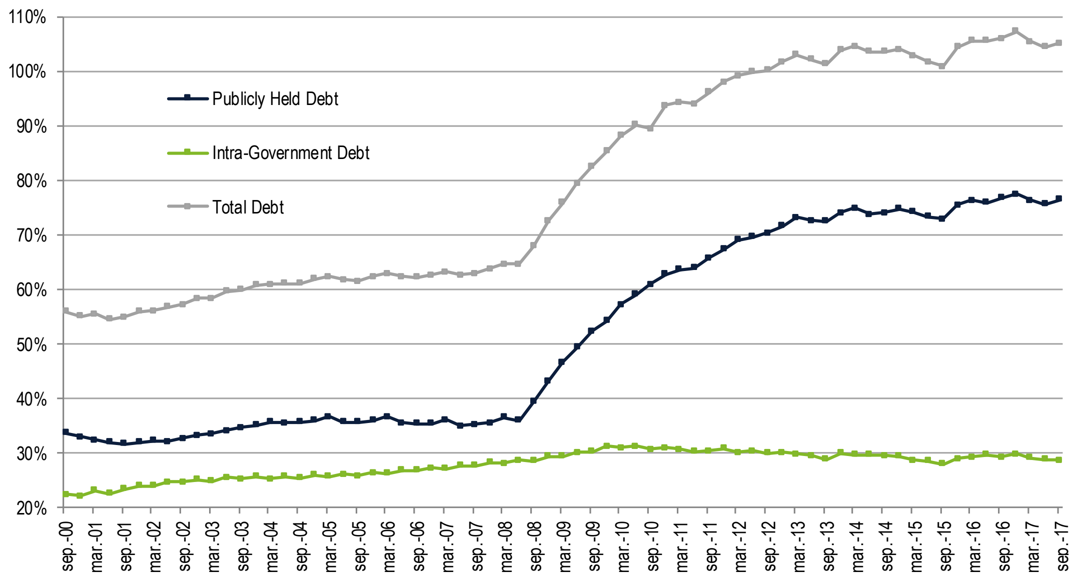
Source: HR Ratings with information from the BEA and Treasury.

[3] Congressional Budget Office: Monthly Budget Review for September 2017.

It is important to note, however, that for various technical reasons, the change in the public debt does not exactly follow the deficit. Larger positive deviations (change in debt vs. deficit) begin with the 2008 financial crisis and were particularly large during FY16 and in some compensatory form we are currently seeing (i.e., the last three data points) relatively significant negative deviations. These negative deviations have resulted in the small increase in the debt during FY17. Over the longer term, however, we would expect the two series to largely coincide despite occasional deviations as was the case prior the 2008 financial crisis.

As for the debt, in Graph 2 it is presented the evolution of the total debt, publicly held debt and intra-governmental debt as percentage of LTM GDP. The sudden increase in the debt to GDP ratio during the financial crisis is evident. The relationship began to stabilize during 2013 but rose again during 2016 due, as it has seen in Graph 1, the positive deviation between the deficit and the change in the debt. Going forward, we would expect the level to remain relatively stable, at least until the current period of negative deviations persists. Thereafter, the level of debt will depend on various factors.

Graph 2: United States Debt as share of GDP (LTM)

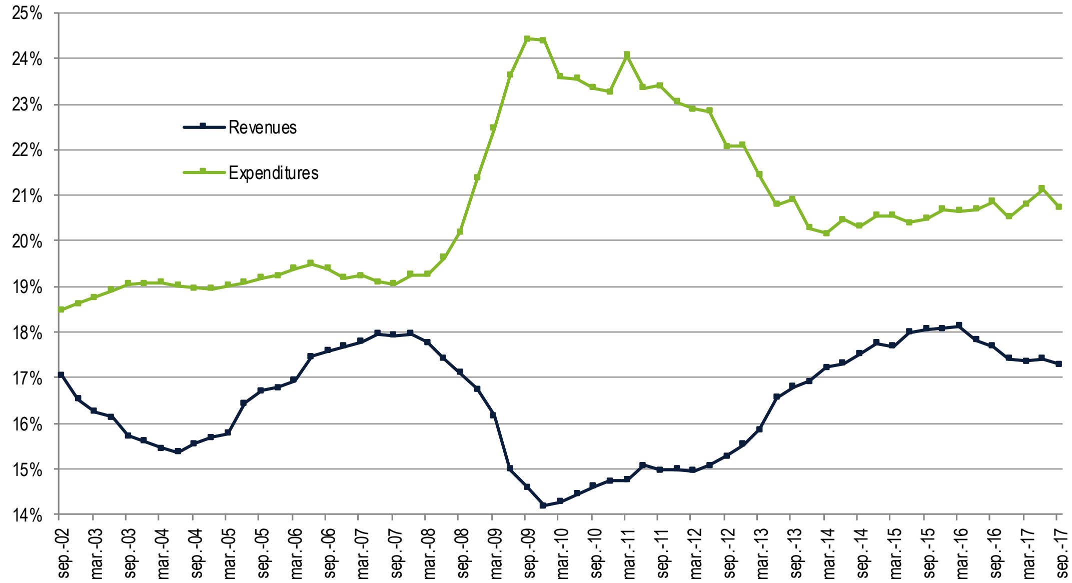


Source: HR Ratings with information from the BEA.

Growth and Revenues

Real GDP Growth will likely have to move to around 2.5% or more on a sustained basis to prevent the downward trend seen in Graph 3 from continuing, or reasonably to be able to expect revenues to return to 18% highs. Those highs appear difficult to reach but it may be imperative to do so given current higher levels of spending. Stronger growth would not only support higher levels of revenue, even relative to GDP, but might also reduce pressures on spending. Of course, the future evolution of revenues is currently a major question given the debate concerning potentially major changes in the tax code.

Graph 3: LTM Revenues and Expenditures as share of GDP



Source: HR Ratings with information from The Treasury Department.

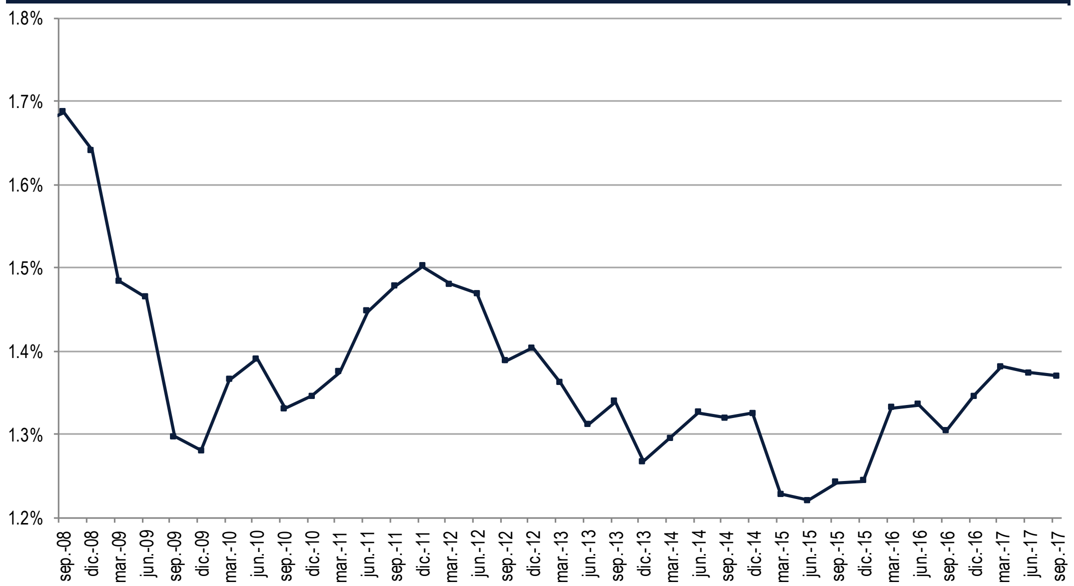
Expenditures

The last data point in Graph 3 for expenditures suggests that the upward trend seen since roughly the end of calendar year 2013 might be coming to an end with the stabilization of spending below the 21% level. However, as discussed above once adjustments are made for calendar effects spending might be understated. The CBO believes that the growth numbers in spending understates Medicare and other, or non-entitlement outlays. What happens with Medicaid is currently the subject of fierce debate making predictions for that account highly problematic. As for “other” spending that strong level seen in FY17 is understated according to CBO analysis.

This leaves Defense and interest costs. Defense costs appear to be on a slow long-term decline relative to GDP. For the LTM through FY12 defense spending represented 4.01% of GDP and fell to 2.92% for FY17. From this perspective defense spending does not appear to constitute a driver for rising expenditures. However, a relevant question is whether the international geopolitical environment is sufficiently delicate to suppose that at some point in time a significant increase in defense spending will become probable.

Finally, we have interest expenses. In Graph 4 we show the evolution of net interest expense to trailing twelve months GDP. The trend is upward, although in a somewhat erratic manner. The fact that the real cost of debt for the federal government has been virtually zero or negative for some time now, even as the level of debt has increased substantially has been a major positive element in U.S. public finances. Although we do not believe that inflation is likely to provoke dramatic increases in interest rates (assuming no major tax legislation that might usher in significantly higher deficits) we would expect that the ratio of interest costs to debt will increase.

Graph 4: Interests as share of GDP (LTM)



Source: HR Ratings with information from FRED.

Conclusion

Thus the current tax, regulatory and spending debate in the U.S. needs to consider: 1) the rising levels in the deficit, 2) recent negative deviations in the relationship between the increase debt and the deficit, which deviations might not continue indefinitely, and which have temporarily restrained the increase in the public debt, 3) the expectation of rising interest rates and the impact on the size of financial costs, 4) structural increases in non-defense expenditures and recent declines in revenue to GDP, 5) the possible need to significantly increase defense costs at some point in time, 6) recent slow economic growth, the benefits of increasing it, and possible limits to how much that growth rate might increase even with tax and regulatory reform.

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