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Government of United States of America

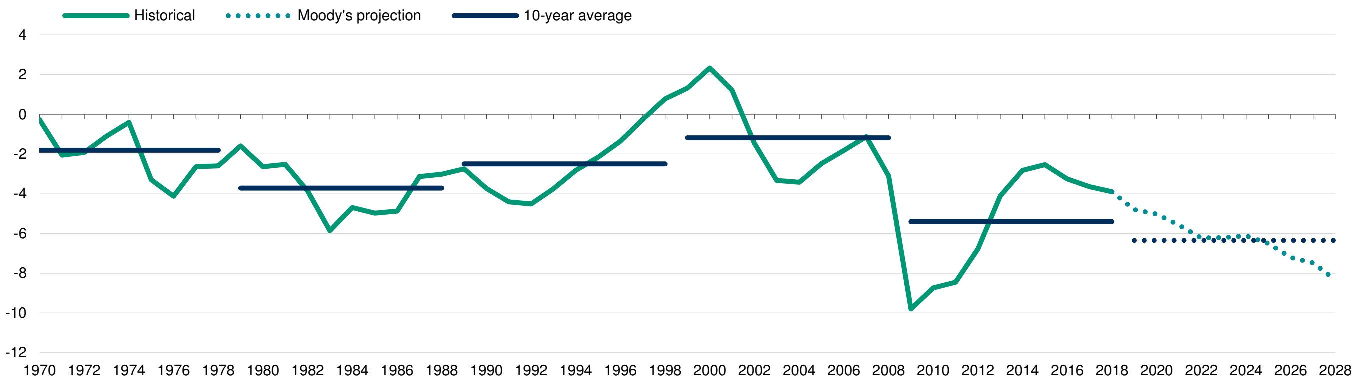
Widening federal budget deficit foreshadows gradual longer-term decline in US fiscal strength

On 15 October, the US (Aaa stable) Department of the Treasury reported that the federal budget deficit increased to $779 billion, or 3.9% of GDP, in the fiscal 2018, which ended 30 September 2018, up from $666 billion, or 3.5% of GDP, the previous fiscal year. The fiscal 2018 budget deficit is the largest since 2012 relative to GDP and reflects the beginning of what we expect to be a continued widening of US fiscal deficits over the next decade. Recent tax cuts and increased expenditures, combined with ageing-related entitlement spending and higher debt-service payments, will drive deficits in the coming years. In the absence of policies to offset adverse fiscal dynamics, the federal debt burden will continue to rise and debt affordability will decline, resulting in an overall weaker fiscal position for the US sovereign, a credit negative.

According to the Treasury's report, nominal receipts increased by only 0.4% relative to fiscal 2017, resulting in a decline in the receipts-to-GDP ratio to 16.5% from 17.2% in fiscal 2017. Total receipts were driven by higher individual income tax revenues (up 6.1%) that were largely offset by a fall in corporate income tax (down 31%). Meanwhile, nominal outlays increased by 3.2%, resulting in an expenditure-to-GDP ratio of 20.3% compared with 20.7% in fiscal 2017. Outlays were driven by a 23.6% increase in net interest costs, a 2.5% increase in spending on major entitlement programs (Social Security, Medicare and Medicaid) and substantial disaster relief.

We expect rising funding costs, mounting entitlement spending and increases in military spending to cause federal outlays to rise in fiscal 2019. Absent at least partially offsetting measures, these expenditure trends, combined with our assumption that tax provisions set to expire in 2025 would likely be made permanent, would cause the federal deficit to exceed 8.0% of GDP by fiscal 2028. This is a level that has not been reached since the 2008-09 global financial crisis (see exhibit).

The US' fiscal deficits will widen in the absence of policies to offset rising entitlement and funding costs
Federal budget deficit as a percent of GDP



Sources: Congressional Budget Office and Moody's Investors Service

Increases in future expenditures will be driven largely by rising interest payments on federal debt, which will rise materially because of rising interest rates, and the rising cost of social security and major healthcare programs. We expect debt service to account for more than half of the deterioration in the fiscal deficit by fiscal 2028. As a result, on the basis of current policy settings, we estimate that the federal debt trajectory will rise by around 30 percentage points by fiscal 2028, to surpass 100% of GDP, and the ratio of interest payments to revenue will rise by about 15 percentage points from about 8% in 2017.

The 6 November midterm elections will determine control of the US Congress, with polling data suggesting that the Democratic Party could regain control of the House of Representatives from the Republican Party, an outcome that would leave Congress divided provided the Republicans maintain control of the Senate, as most political analysts expect. We do not expect the midterm elections to materially affect US fiscal policy, given that neither party is currently proposing a viable policy response to longer-term fiscal challenges, including rising ageing-related entitlement spending.

Despite these fiscal pressures, the US continues to stand out as a sovereign with an unusually high ability to carry a large government debt burden, owing to its exceptional economic strength and the unique and central roles of the US dollar and US Treasury bond market in the global financial system, which will help counterbalance the gradual decline in fiscal strength.

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