US Daily: What Happened to the Deficit? (Phillips)

- The budget deficit totaled $1.695 trillion in FY2023 (6.3% of GDP), up from $1.375 trillion (5.4% of GDP) in FY2022, as reported by the Treasury. However, there were several one-off factors that obscure the underlying deterioration on net, including student loan accounting, financial sector support, and a delayed tax deadline. Accounting for these and other adjustments, the underlying deficit expanded from $1.1 trillion to $1.8 trillion, or from 4.5% to 6.8% of GDP.
- A decline in tax receipts accounted for more than the entire deterioration in the deficit, when considered in shares of GDP—i.e., spending declined but was more than offset by the decline in revenues. The main culprit was non-withheld tax receipts, which dropped due to lower capital gains realizations in 2022, we believe. This likely accounted for around 1pp of the widening in the deficit this year. There were other smaller factors, like a surprisingly large amount of payments for the Employee Retention Tax Credit (ERTC).
- From here, we expect a modest narrowing of the deficit in FY2024, to $1.7 trillion (6.0% of GDP) before widening again in FY2025 to $1.9 trillion (6.5% of GDP). We don't see any major opportunity for fiscal policy changes until 2025, when the debt limit must be raised again and the personal tax cuts enacted in 2017 expire (at the end of 2025).

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What Happened to the Deficit?

The Treasury reports that the deficit totaled $1.695 trillion in FY2023 (6.3% of GDP), up from $1.375 trillion (5.4% of GDP) in FY2022, as shown in Exhibit 1. This reflects a decline in receipts led by non-withheld personal income tax receipts (down nearly $300bn), which was partly offset by a decline in spending.

Exhibit 1: A Decline in Tax Receipts Accounted For More Than the Entire Deterioration in the Deficit

	Billions		% of GDP		Change ('22 to '23)	
	FY2022	FY2023	FY2022	FY2023	$bn	% of GDP
Receipts						
Withheld Income Tax	1732	1695	6.8	6.3	-37	-0.6
Nonwithheld Inc. Tax	1147	855	4.5	3.2	-292	-1.4
Corporate Tax	476	457	1.9	1.7	-19	-0.2
Payroll Tax	1489	1621	5.9	6.0	132	0.1
Federal Reserve	107	1	0.4	0.0	-106	-0.4
Other Receipts*	374	222	1.5	0.8	-152	-0.7
Individual Refunds	-246	-373	-1.0	-1.4	-127	-0.4
Corporate Refunds	-51	-38	-0.2	-0.1	14	0.1
Total Receipts	**5027**	**4439**	**19.9**	**16.5**	**-587**	**-3.4**
Spending						
Health Benefits	1441	1562	5.7	5.8	122	0.1
Social Security	1282	1416	5.1	5.3	134	0.2
Other benefit programs	903	694	3.6	2.6	-209	-1.0
Defense	727	776	2.9	2.9	49	0.0
FDIC & PBGC	-7	132	0.0	0.5	139	0.5
Other spending*	1188	1221	4.7	4.5	33	-0.2
Interest	489	666	1.9	2.5	177	0.5
Student Loan Forgiveness	379	-333	1.5	-1.2	-712	-2.7
Total Spending	**6402**	**6134**	**25.3**	**22.8**	**-268**	**-2.5**
Reported deficit	**-1375**	**-1695**	**-5.4**	**-6.3**	**-320**	**-0.9**

* Spectrum auctions are categorized in official data as offsetting receipts in the spending category; we instead show them as receipts. As a result, the totals above differ slightly from the reported figures.

Source: Treasury, Goldman Sachs Global Investment Research

However, a number of one-off factors contributed more than usual to the widening of the deficit. For example, the federal government collected $131bn in radio spectrum auctions in FY2022 that were not repeated in 2023. The delay of tax filing deadlines for most California residents also likely shifted around $60bn in tax receipts from earlier in 2023 into October (i.e., FY2024). On the spending side, financial support for a few sizable banks and pension funds cost the government more than $100bn. Working in the opposite direction, accounting for the cost of President Biden's student loan forgiveness plan added roughly $379bn to the deficit in FY2022 but reduced the reported deficit by $333bn in FY2023 when that plan was rescinded following the Supreme Court ruling in June that blocked the plan. Removing the effect of all these technical factors shows a greater expansion in the underlying deficit than the officially reported figures imply, from 4.5% to 6.8% of GDP.

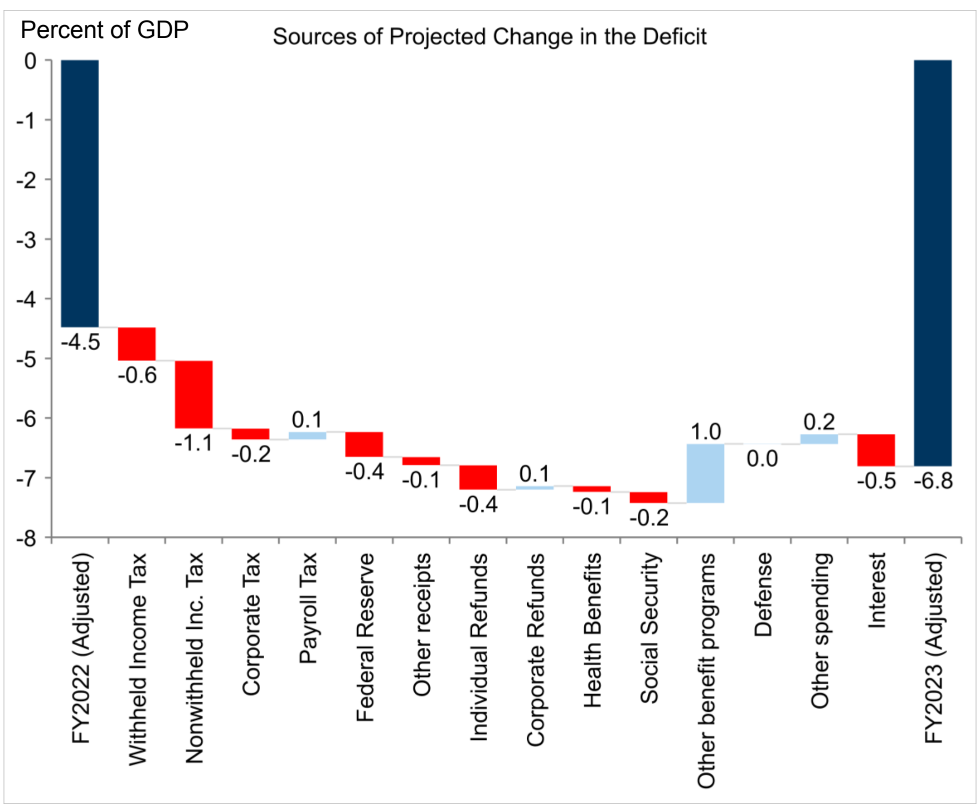
Exhibit 2: Removing the Effect of One-off Factors Shows a Greater Expansion in the Underlying Deficit

	Billions		% of GDP		Change ('22 to '23)	
	FY2022	FY2023	FY2022	FY2023	$bn	% of GDP
Receipts	**5027**	**4439**	**19.9**	**16.5**	**-587**	**-3.4**
Remove spectrum auctions	-131	0	-0.5	0.0		
Adjust for tax deadline delay	0	60	0	0.2		
Total Receipts after adjustments	**4896**	**4499**	**19.3**	**16.7**	**-397**	**-2.7**
Spending	**6402**	**6134**	**25.3**	**22.8**	**-268**	**-2.5**
Remove student loan accounting	-379	333	-1.5	1.2		
Remove FDIC & PBGC	7	-132	0.0	-0.5		
Spending after adjustments	**6030**	**6336**	**23.8**	**23.5**	**306**	**-0.3**
Deficit after technical adjustments	**-1134**	**-1836**	**-4.5**	**-6.8**	**-702**	**-2.3**

Source: Treasury, Goldman Sachs Global Investment Research

After adjustments, the deficit increased by an even more sizable 2.3% of GDP, as shown in Exhibit 2. It is important to consider the change as a share of GDP rather than nominal increases in spending, as the various items should, on average, grow by roughly the same pace as GDP for the deficit to remain constant as a share of GDP. When considered this way, the decline in tax receipts accounted for more than the entire deterioration—i.e., spending declined but was more than offset by the decline in revenues.

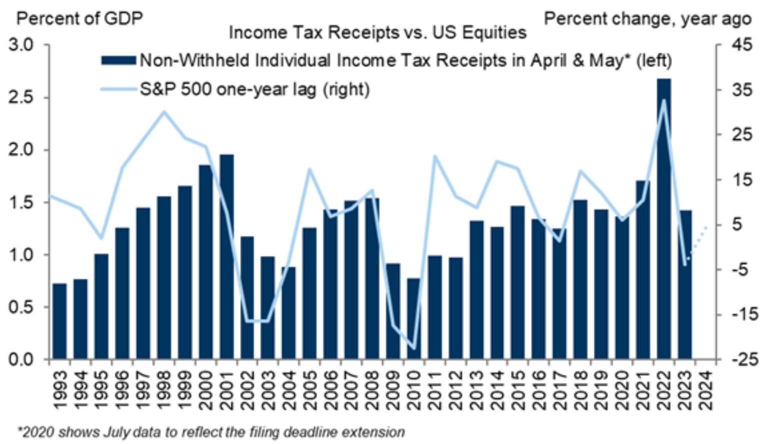
Exhibit 3: The Decline in Tax Receipts Accounted For More Than the Entire Deterioration in the Deficit



Source: Treasury, Goldman Sachs Global Investment Research

The largest single factor on the revenue side was weak non-withheld income taxes, primarily those paid with last year's tax filings in April 2023. These were down roughly 1% of GDP even after adjusting for the delayed tax deadline. This likely reflects the unusually high level of capital gains-related taxes in 2022, not an unusually low level in 2023. There is no reason to expect further deterioration in this segment of taxes—a small rebound in FY2024 seems more likely—but a return to the previously elevated level of non-withheld receipts (as a share of GDP) seems very unlikely.

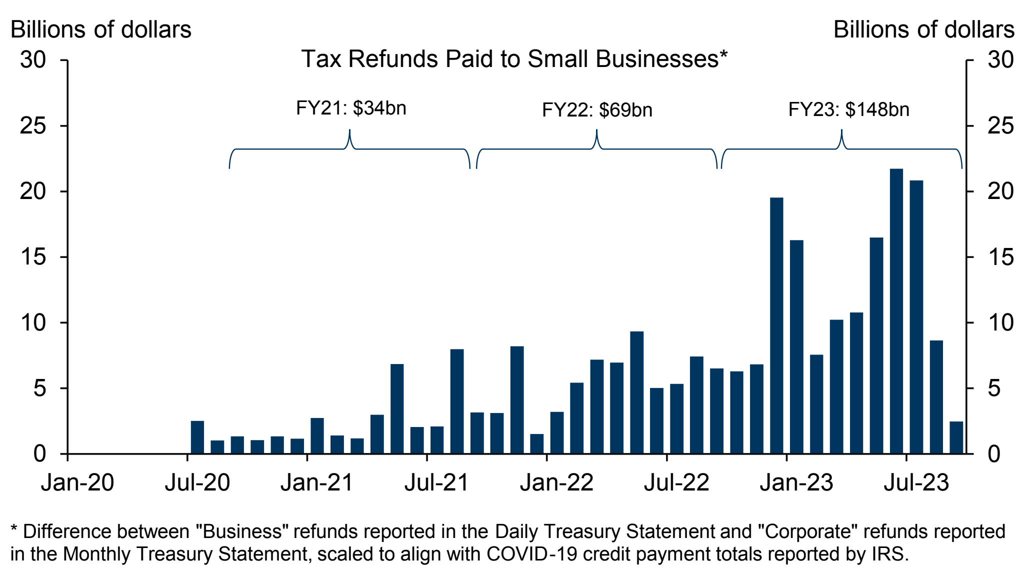
Exhibit 4: The Unusually High Level of Capital Gains-Related Taxes in 2022 Declined in 2023



Source: Treasury, Bloomberg, Goldman Sachs Global Investment Research

A smaller reason for the fall in net tax collections is a substantial rise in tax refunds related to the Employee Retention Tax Credit (ERTC), a pandemic-era credit to incentivize employers to retain staff. Although only wages paid in 2020 and 2021 are eligible for the credit (up to $36k per employee), businesses continue to claim it retroactively. Processing of these claims has paused until the next tax filing season begins in early 2024, but it is likely that additional refunds will be paid then as well.

Exhibit 5: Refunds Related to the Employee Retention Tax Credit Have Risen Substantially



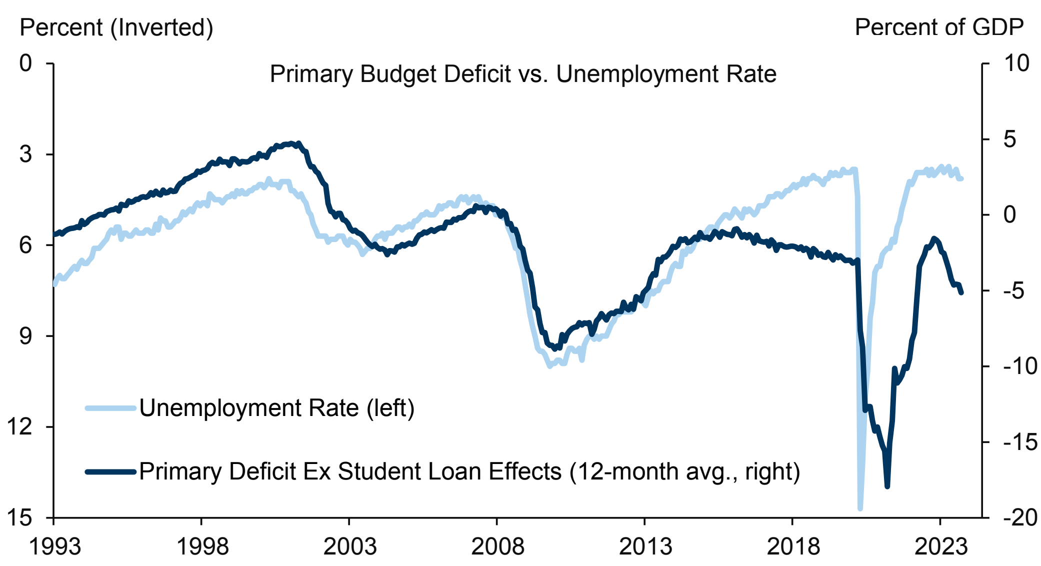
Source: Treasury, Goldman Sachs Global Investment Research

While the ERTC expanded the deficit, on the whole spending on pandemic-related programs declined substantially in FY2023 compared to FY2022. This includes a $106bn decline in spending from the Coronavirus Relief Fund (CRF), which provided fiscal support to states, a $64bn drop in spending from the Public Health and Social Services Emergency Fund (PHSSEF), which provided support for public health, and a $15bn drop in spending from the Education Stabilization Fund (ESF). More generally, tighter post-pandemic policies slowed spending in Medicare, Medicaid, food stamps, and a variety of other benefit programs in FY2023.

It is also worth noting what did not cause the deficit expansion. Although Congress has approved three major infrastructure laws to fund investment in semiconductors, green energy, and transportation, the recent deficit expansion appears to have little to do with those programs. Spending out of the Dept. of Transportation related to the programs funded by the 2021 infrastructure law looks roughly flat, and there has not yet been any clear sign of an uptick in tax credits or other payments related to semiconductor or green incentives.

Likewise, although entitlement programs remain the biggest medium-term fiscal challenge, spending in entitlement programs was not a major cause of this year's deficit widening. While a $256bn dollar increase in spending on health benefits and Social Security sounds high, they accounted for only around 10% of the total widening of the deficit, despite accounting for around 1/3 of total spending. That said, over the next several years, this growth is likely to continue due to an aging population and increased per capita health spending, so while these programs are not the main story this year, they are likely to be the main story in the worsening fiscal outlook over the next decade.

Exhibit 6: A Deficit This Large Is Extremely Unusual in a Period of Reasonably Strong Growth and a Very Tight Labor Market



Source: Treasury, Bureau of Labor Statistics, Goldman Sachs Global Investment Research

As we have pointed out previously, a deficit of this size is extremely unusual in a period of reasonably strong growth and a very tight labor market (Exhibit 6). To some extent, this is because weaker growth reduces tax receipts and increases spending. But it is mainly because Congress tends to ease fiscal policy during and following recessions. Since much of the recent deficit widening is due to one-off factors, we do not think the change in the deficit provided nearly as much stimulus to growth as a swing of more than 2% of GDP would normally suggest. We expect a narrowing in the gap next year, to $1.7 trillion (6.0% of GDP) before widening again in 2025 to $1.9 trillion (6.5%). In 2025, another debt limit debate and the expiration (at the end of 2025) of the personal tax cuts enacted in 2017 could lead to a more fulsome debate on tax and spending changes, but in the meantime, we see little chance of a shift in the direction of fiscal policy.

Alec Phillips

Disclosure Appendix

Reg AC

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