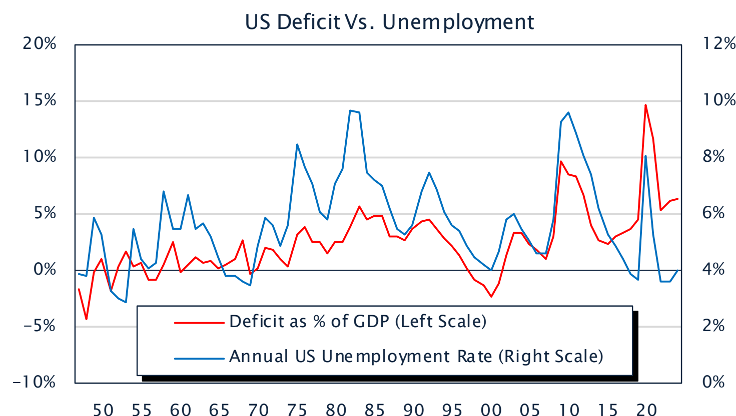
MARCH 2025

INVESTMENT UPDATE

These days, the term "fiscal policy" encompasses the entirety of how a central government collects and spends money. But once upon a time (really, only a few years ago), fiscal policy was a school of macroeconomic thought. As envisioned by the father of fiscal orthodoxy, British economist John Maynard Keynes, fiscal policy refers to the actions a central government can take, using its taxing and spending powers, to achieve a desired economic outcome. Keynesian fiscal policy dictates that a government's treasury should run surpluses when its economy is strong, and only run deficits when the economy needs a shot in the arm. The idea is that policymakers, using skill and timing, can take out some of the excesses (e.g., inflation) from a too-hot economy by increasing taxes, and alternatively increase government spending (or even cut tax rates) when the economy is struggling, helping to dampen both the peaks and valleys of the business cycle.

Keynesian economics was developed in the wake of the Great Depression, and guided US policymakers after World War II, as huge wartime budget deficits, which reached 27% of US GDP in 1943, had to be whittled down. A booming US economy and high tax rates quickly turned deficits into surpluses by 1947. Over the next two decades, the US had a "balanced budget," running surpluses in strong economic times and deficits when the economy slowed. The chart on this page (which shows surpluses as negatives) demonstrates how deficit spending was used in the 1950s and 60s during periods of rising unemployment—and even then, deficits were small, with only one year from 1947 to 1966 with an annual deficit higher than 2% of US GDP. By 1970, another war (this time in Southeast Asia) was winding down, and with the US unemployment rate back below 4% the US was once again taking in more revenue than it was spending.



This was "peak Keynes," as the kids might say, because after 1970, the US entered into a period where nothing seemed to go right with fiscal policy. The energy crisis of the early 70s crushed US economic growth and sent both inflation and unemployment above 10%, followed by a series of policy errors, including misguided efforts at price controls. By the end of the 1970s, Keynesian economics had been thoroughly discredited.

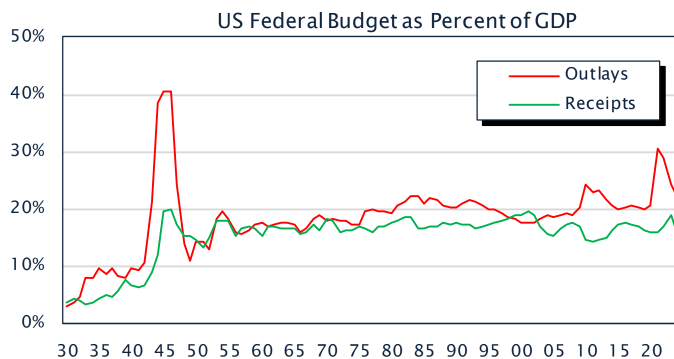
In its place "monetarism" stepped up to the plate, led by economist Milton Friedman and put into action by Federal Reserve Chairman Paul Volcker. Monetarists scoffed at the idea that an economy could be fine-tuned by bureaucrats, as the inevitable lags that occur between the enactment of policies and their intended results will never provide the real-time feedback that would be needed to adjust policies when necessary, much less fine-tune them. Monetarism, at its core, viewed money—and specifically, the supply of money—as the key variable influencing economic activity; increase the money supply and the economy will accelerate and inflation will rise; cut the supply of money and the economy will shrink and so will inflation. It's important to note that Friedman didn't believe monetary policy could be used to fine-tune an economy any better than fiscal policy; rather, he believed that steady, moderate growth in the supply of money would lead to stable economic conditions and smoother business cycles.

The rise of monetarism coincided with Ronald Reagan's "supply side" economic policies, which asserted that lower taxes would stimulate growth—and US Treasury receipts—more than the losses from reducing marginal tax rates. The US economy did indeed grow strongly for most of the 1980s, and controlling the growth of the money supply brought inflation down, but supply side economics did not deliver the increase in tax revenues that were promised. As a result, budget deficits remained historically high for most of the 80s and into the 1990s. It took subsequent income tax rate hikes from both the George H.W. Bush and Bill Clinton administrations, and the "peace dividend" from reduced defense spending, to square up the US fiscal ledger, leading to budget surpluses from 1998-2001.

But even before the end of the 1980s, monetarism began adopting elements of Keynesian economics. Simply measuring the money supply grew increasingly difficult under Volcker, as new financial instruments, including short-term money market securities, helped to pull money out of bank checking and savings accounts and into brokerage accounts. The Fed switched from the difficult task of measuring and controlling

the money supply to targeting inflation and growth by controlling short-term interest rates under Volcker's replacement, Alan Greenspan. By raising or lowering the cost of borrowing overnight funds between banks, the Fed saw that it could, with delays, effect the speed of the economy. More to the point of this discussion, the lines between monetary policy and fiscal policy blurred, as the Fed's active management of overnight lending rates demonstrated exactly the kind of fine-tuning of the economy that the monetarists had once so bitterly criticized.

The budget surpluses of 25 years ago are now just a distant memory, as the US economy entered into a new phase of fiscal indiscipline with the turn of the century. In fairness, there were three major events that increased spending dramatically: rapid growth in defense spending in the wake of terrorist strikes on September 11, 2001; the allocation of billions of dollars to shore up the financial system after the 2007-08 global financial crisis; and emergency spending in 2020 and 2021 to support households and businesses during the COVID pandemic. We would also add the impact of the Affordable Care Act in 2010, which expanded Medicaid benefits by billions of dollars. These events also corresponded with changes in demographics that necessitated increased spending, especially on retirement and medical benefits, as the US population continued to grow older.



The result is that the Fed, for at least the last 20 years, has been conducting monetary policy against a backdrop of profligate fiscal policies. As the chart on this page shows, budget deficits in the 21st century are a result of both too little income coming into the treasury and too much spending. This is a self-inflicted problem, and yet, there seems to be little desire among most policymakers to do anything about it. Raising marginal tax rates is viewed in Washington as a "third rail" issue, and yet, even when the economy is strong, we're barely able to generate annual tax receipts of more than 17% of US GDP. Note that the Clinton/Bush budget surpluses were the last time we got near the level where receipts reached 20% of GDP. Personal and corporate tax rates have been lowered multiple times since the last time we had a budget surplus.

Likewise, spending has spiraled up over the past 25 years, and during COVID in 2020, breached the 30% of GDP barrier for the first time since WWII. As mentioned above, we've had three "generational" events in the past 25 years that have each demanded massive fiscal injections, but we've also enjoyed long periods of decent economic growth with low unemployment; in other words, we've had opportunities to cut spending in order to re-align revenues and costs, and we have failed to do so. The blame ultimately lies with policymakers, and specifically with Congress, which has the responsibility to prioritize how money is spent, but they have little incentive to cut programs that are popular with their constituents. Reelection is, presumably, the main objective.

While we welcome efforts to "find waste" in US government spending (who wouldn't?), we're not all that optimistic that the current flurry of threatening emails to Federal employees will result in significant savings (personnel costs make up only around 4% of US government spending). At this point, we need to consider a major overhaul of both tax policies and spending priorities. On the spending side, that must include the major health care programs, which will, in the next five years, become the largest category of US government expenditures, exceeding the total of all "discretionary" items combined (which includes defense spending). The US continues to have the most expensive health care in the world (nearly twice as expensive as other major developed nations, on average), and, statistically speaking, comparatively much worse outcomes than what citizens of other countries experience. The Congressional Budget Office (CBO) is forecasting that the cost of these major healthcare programs (including Medicare and Medicaid) will increase by more than 50% over the next decade. Likewise, there are big savings available—in the trillions of dollars—from making certain changes to Social Security benefits and taxes that don't involve taking benefits away from those who need (and paid) for them.

Without significant reform on both sides of the ledger, the CBO is forecasting baseline deficits of at least 5% of GDP per year, indefinitely. What that means is that the US' accumulated debt, which is currently at 98% of 2025 US GDP, will grow to almost 120% in ten years. With a growing debt burden comes an increase of debt service, particularly with interest rates hundreds of basis points higher today than a few years ago. The CBO tells us that interest costs alone will equal 18% of federal revenues this year, growing to 22% in ten years' time; it was 7% a decade ago. A growing interest burden further strains the budget and takes money away that would be otherwise available to other programs.

A full rundown of spending and taxation options is clearly beyond the scope of a two-page discussion. If you're interested in reading more, the Peterson Foundation, the American Enterprise Institute, and the Bipartisan Policy Center are three good sources of information and possible solutions to our budget issues. And if you want to play with numbers, the Committee for a Responsible Federal Budget website has an interactive page that allows you to be the US fiscal czar and make the changes you'd like to see (crfb.org/debtfixer). Good luck!