A CEO's big picture view of the nation's financial health

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While the U.S. budget deficit was not a top concern after the financial crisis, Ted Truscott explains why it deserves our attention now.

William F. "Ted" Truscott
Chief Executive Officer

The financial health of Columbia Threadneedle Investments — and our clients — is always top of mind for me. And I also know it's important to keep an eye on what's happening at a national level with government budget deficits and debt. This broader view comes with some difficult facts to accept, but it's crucial to understand the effect our national finances can have on the markets and the financial advisors and investors we serve.

Not much attention has been paid to the budget deficit since we emerged from the financial crisis in 2010. The economy has improved. Tax revenues have increased. And the large deficits we experienced between 2008 and 2010 have largely receded. However, with the debt ceiling back in the news, it's important to take a closer look at the current budget deficit and the lack of progress we've made in lowering the national debt — and what that could mean for financial advisors and investors.

The deficit is featured prominently in the government's latest plan to carry out tax reform. Of course, no one *wants* to add to the deficit. But lower tax rates create a loss in revenue, and any attempts to lower rates and simplify the tax code must be accompanied by off-setting revenue generating measures.

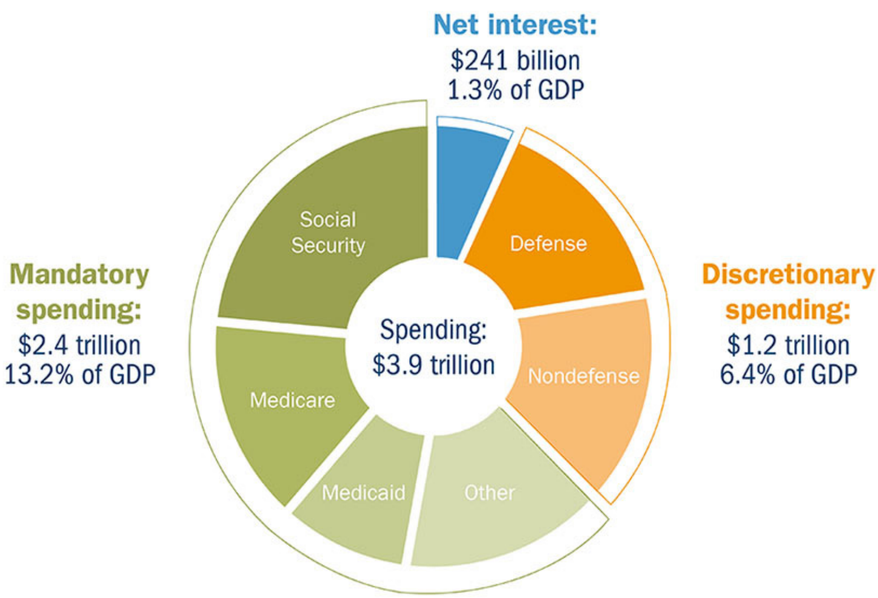
The truth about the U.S.'s finances

Every year, the non-partisan Congressional Budget Office (CBO) tallies up the nation's revenues and spending in a report on the federal budget that makes for straightforward but sobering reading when you consider the implications of budget deficits and debt on the nation's financial health.

The budget deficit for 2016 was $587 billion, which was an increase from previous years. It was not as large as the deficits incurred during the financial crisis, but over time it adds up. As a result, total debt issued by the United States and debt held by the public (including foreign investors) totaled 77% of gross domestic product (GDP). **This is the highest ratio of debt to GDP since 1950.** We're also financing this debt at record low interest rates. Net interest paid to holders of U.S. debt amounted to $241 billion, or 1.3% of GDP. Any rise in interest rates will make this number much larger.

Debt often has a negative connotation, but it's not *always* a bad thing, especially if it's used to finance future growth. However, a lot of the spending that leads to deficits (and in turn increases our nation's indebtedness) is for mandatory payments by programs like Social Security and Medicare, which have a specific purpose, but don't necessarily have a positive multiplier effect on the country's economic growth. The United States spent $3.9 trillion in 2016, and of that total 61.5%, or $2.4 trillion, is mandatory.

Federal spending totaled $3.9 trillion in 2016 while revenue totaled only $3.3 trillion



Source: Congressional Budget Office, February 2017. Figures are for fiscal years, which run from October 1 to September 30.

Discretionary spending is made up of two categories — defense and non-defense. Almost every government program *other than* Social Security, Medicare and Medicaid is found in non-defense spending. But non-defense spending made up only 15.38% of 2016 expenditures.

The vast majority of the federal government's revenues comes from payroll and income taxes paid by corporations and individuals. In 2016, payments into Social Security were $1.1 trillion, exceeding outlays of $910 billion. This trend is expected to reverse itself as more and more baby boomers retire and live longer, resulting in the reduction of Social Security surpluses. If this happens, eventually the system will run out of money, unless changes are made.

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The challenges of tax reform

One of the biggest considerations for many investors is how taxes affect their ability to grow their wealth. The challenge of achieving tax reform that significantly lowers rates should be viewed in the context of these deficit and debt figures. To avoid substantial revenue loss, lawmakers will focus on curtailing or ending certain tax deductions on things like mortgage interest, state and local taxes and charitable contributions. There has been some talk about limiting deductions for contributions to 401(k) plans and making some or all future contributions so-called Roth contributions. So, while the facts and their potential effects on U.S. investors can feel overwhelming to say the least, any tax reform will produce a great deal of debate. And it will be only heightened by an increased focus on the national debt.

The bottom line

Keep a close eye on the budget resolution debate. Approval of a fiscal year 2018 budget will be an important step and will lay the foundation for tax reform. How comprehensive the tax reform will be, and what this could mean for the country's deficit, remains to be seen. If nothing is accomplished, the markets could be vulnerable. Regardless, the best measure is to be prepared and armed with knowledge by maintaining a broader view on the financial health of the country.

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