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U.S. BUDGET CUTS: TIGHTROPE WALKING

Executive Summary

- The key question for investors is how cuts to the federal workforce could impact the overall labor market. On one hand, federal government employment accounts for less than 2% of total nonfarm payrolls. On the other hand, second-round effects of the government's efforts to slash spending could be much more material.
- A smaller budget deficit is key to stabilizing the upward trend in the debt-to-GDP ratio, and the importance of achieving this outcome is garnering growing consensus among political circles. Our view is that a combination of higher productivity and price inflation growth rates could boost nominal GDP growth and therefore contribute to this process.
- However, any attempt to address the budget imbalance could prove fleeting without long-term solutions aimed at reining in "mandatory" spending or increasing revenues. These solutions could represent a drag on economic growth in the near term. They would also be very unpopular and would therefore require strong and bipartisan willingness to act within the government.
- In this environment, economic uncertainty and market volatility may remain elevated, therefore reducing the risk of significantly higher long-term bond yields, which should support the attractiveness of high-quality fixed income securities. As a result, we continue to believe that investors are better served by remaining diversified within and across asset classes.

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Investors have become more attuned to the risks stemming from the Trump administration's objectives of slashing federal government spending, significantly reducing the federal workforce, and ultimately cutting the budget deficit from its current 7% of Gross Domestic Product (GDP) to 3%.

In this new Focus*Point*, we answer some key questions about how this policy framework could impact the U.S. economy and financial markets, explore what potential levers are at the government's disposal to achieve the desired result, and analyze what real-time data reveals about the progress so far.

How could spending cuts impact the labor market and household consumption?

President Trump's executive order asserting the need to "eliminate waste, bloat, and insularity" kicked off a process that could lead to significant job losses across the federal government. The key mandate is for each federal agency to identify positions "not mandated by statute or regulation who are not typically designated as essential during a lapse in appropriations." During recent "lapses in appropriations" (or government shutdowns), approximately 2.3 million federal workers were deemed essential, leaving around 700,000 nonessential workers. While it is unclear how many of these jobs could be cut, the magnitude makes it likely that federal government employment might decline significantly over the next few months.

Hence, the key question for investors is how these cuts could impact the overall labor market. On one hand, federal government employment accounts for less than 2% of total nonfarm payrolls. As a result, the direct implications of federal job cuts could be relatively limited. On the other hand, second-round effects of the government's efforts to slash spending (whether executed by the Department of Government Efficiency [DOGE], which is more likely to be challenged in court, or through Congress) could be much more material. We identify three potential channels:

1. State and local (S&L) government employment accounts for 13% of total nonfarm payrolls. As a result, if federal transfers to S&L administrations—representing more than one quarter of their general revenue—are affected by broad-based spending cuts, this could potentially present a bigger risk for the overall labor market.

2. In the same vein, cutting federal contracts and grants to the private sector could eliminate a crucial source of funding, and therefore employment growth, in certain industries. Figure 1 shows what industries could be more at risk in this scenario.

3. Finally, achieving the sizeable spending cuts that have been proposed by the House of Representatives (House), which we discuss more in depth below, could affect some federal programs that play a key role in directly or indirectly stimulating private consumption. For example, the Congressional Budget Office (CBO) estimates that each dollar transferred by the federal government to individuals could produce as much as $2.1 of additional spending into the U.S. economy (Figure 2). As a result, cutting these transfers could indirectly dampen private consumption. Tax cuts could partly offset this dynamic; but given that there might be little political appetite in Congress for anything besides extending existing tax cut provisions (Tax Cuts and Jobs 2017 Act, or TCJA), the incremental stimulus effect could be smaller than the drag caused by spending cuts.

FIGURE 1

Federal contracts represent a key source of funding for some industries.

Industry (Private Sector)	Value of Federal Contracts ($ Million)	Industry GDP ($ Million)	Value of Federal Contracts as % of Industry GDP	Nonfarm Payrolls ('000)	% of Total NFP
Professional, Scientific and Technical Services	232,600	2,399,200	9.7%	11,054	8%
Manufacturing	240,500	2,925,100	8.2%	12,873	9%
Administrative and Support and Remediation Services	57,200	930,500	6.1%	9,355	7%
Construction	47,300	1,318,600	3.6%	8,316	6%
Finance and Insurance	47,200	2,185,100	2.2%	6,771	5%
Transportation	18,900	978,700	1.9%	6,630	5%
Educational Services	4,900	332,300	1.5%	3,912	3%
Information	17,400	1,585,100	1.1%	3,004	2%
Other Services	4,400	623,000	0.7%	5,935	4%
Agriculture, Forestry, Fishing and Hunting	1,500	251,000	0.6%	235	0%
Utilities	2,500	433,700	0.6%	592	0%
Healthcare	11,600	2,230,900	0.5%	22,890	17%
Wholesale Trade	8,600	1,715,400	0.5%	6,192	5%
Accommodation and Food Services	1,500	957,500	0.2%	14,407	11%
Mining and Oil&Gas Extraction	200	390,900	0.1%	596	0%
Arts, Entertainment and Recreation	151	341,100	0.0%	2,693	2%
Retail Trade	789	1,856,300	0.0%	15,677	12%
Real Estate	1,400	4,048,400	0.0%	2,515	2%
Management of Companies and Enterprises	-	548,100	0.0%	2,570	2%

Source: USASpending.gov, Bureau of Economic Analysis, Bureau of Labor Statistics, TIAA Wealth Chief Investment Office.

FIGURE 2

Federal payments to state and local administrations, as well as to individuals, are estimated to have a considerable multiplying effect on GDP growth.

Fiscal Multipliers*		
Type of Federal Spending/Lost Revenue	**Low Estimate**	**High Estimate**
Purchases of Goods and Services by the Federal Government	1	2.5
Transfer Payments to State and Local Governments	0.7	2.5
Transfer Payments to Individuals	0.8	2.1
Individual Income Tax Cuts	0.2	1.5
Corporate Tax Cuts	0	0.4

Source: Congressional Budget Office, TIAA Wealth Chief Investment Office.

* Low/High estimates of how many additional dollars of economic output are generated by one dollar of federal spending or lost revenue (tax cuts).

Where did the bond vigilantes go?

On February 25, 2025, the House passed a budget resolution that serves as a non-binding blueprint for what is known as the budget reconciliation process. Through this process, Republicans would be able to execute President Trump's fiscal policy agenda with a simple majority in both the House and the Senate. This blueprint calls for $4.5 trillion in tax cuts (likely not enough to cover both a 10-year TCJA extension and new tax cuts), an additional $300 billion for national security priorities like border security, and up to $2 trillion in spending cuts. At face value, this proposal could therefore add $2.8 trillion to the U.S. budget deficit over the next 10 years.

Given investors' growing concerns about the sustainability of the current trajectory of the U.S. national debt, and the potentially sizeable addition to the already elevated budget deficit outlined in this blueprint, it might be surprising to see little-to-no reaction in bond yields. In fact, the 10-year Treasury yield has declined by 10 basis points (bps) since the vote on the budget resolution.

In our view, there are two main reasons for the apparent lack of reaction in bond markets:

1. CBO baseline projections of the debt/GDP[1] ratio over the next decade are built on the assumption that the TCJA will sunset at the end of 2025 (Figure 3). However, since President Trump was elected and the GOP gained a majority in both chambers of Congress in November, it has become clear that these assumptions may be too optimistic, and instead a full extension of all expiring provisions of the TCJA has become the base-case scenario. Financial markets are a discounting mechanism; they seek to price in all available information at any given time. The rise in Treasury yields and the term premium[2] over the two months following the November 2024 election suggests that market pricing started to shift from the CBO's baseline assumption to the reality that tax cuts would be one of President Trump's key policy priorities. Thus, the 2025 budget resolution simply confirmed investor expectations about tax cuts, while also delivering proposed spending cuts that instead might have not been fully reflected in market prices. While the combined effect of these proposals would likely still result in higher

[1] The CBO ratio only considers debt held by the public, not intragovernmental debt.

[2] Defined as the compensation that investors require for bearing the risk that interest rates may change over the life of a bond.

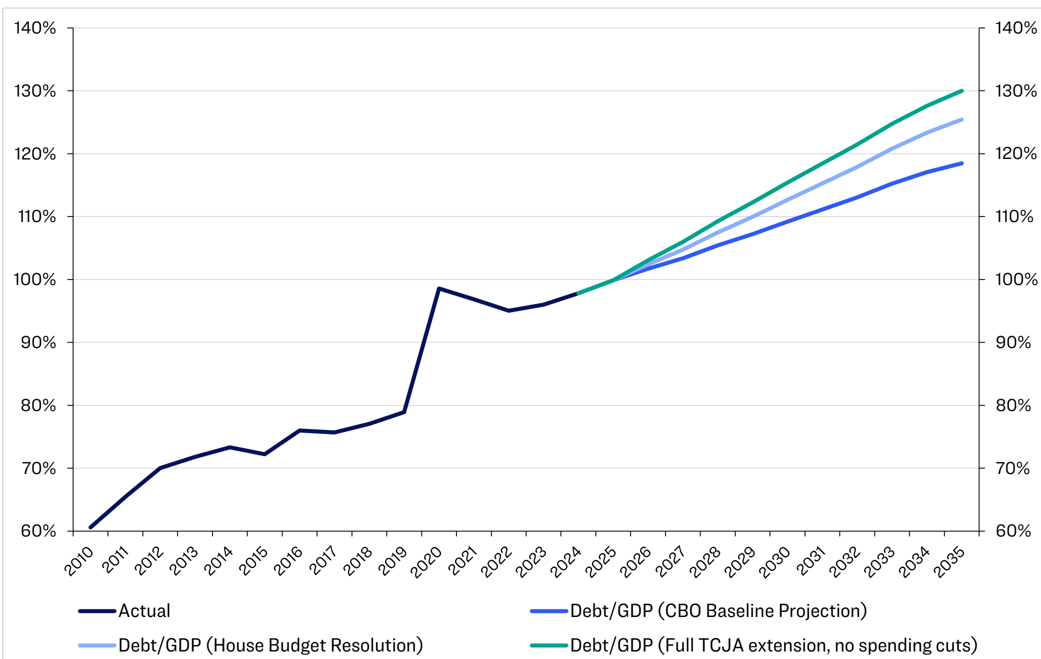
deficits and debt levels over the next 10 years, the magnitude relative to the (out-of-consensus) CBO baseline projection may not be significant enough to worsen fiscal sustainability concerns, at least in the near term.

2. The relatively benign scenario (compared to what bond markets priced in following the November election) has allowed other factors to reassert themselves as primary drivers of bond yields. In particular, growing fears that the sequencing of President Trump's economic agenda (prioritizing tariffs and immigration curbs over more pro-growth policies) poses upside risks to inflation and downside risks to economic growth have engendered market volatility and exerted downward pressure on interest rates as a result.

That brings into question whether "bond vigilantes"—investors who sell government bonds in response to fiscal policies they view as inflationary or irresponsible, driving up borrowing costs for the government—will remain dormant. Not so fast. While the 2025 budget resolution leaves little fiscal room for fresh tax cuts to be implemented, the Republican administration may not easily give up on other policy priorities like eliminating taxes on tips or further cutting the corporate tax rate. Therefore, risks remain that bond volatility might resurface, should unfunded tax cuts rise to the top of President Trump's policy priorities.

FIGURE 3

U.S. Treasury debt held by the public as a percentage of Gross Domestic Product.



Source: Congressional Budget Office, TIAA Wealth Chief Investment Office.

Can the budget deficit improve without causing an economic slowdown?

The short answer is **yes**, and there is a key historical example: the 8 years from 1992 to 2000. During that period, the U.S. budget balance as a percentage of GDP swung from a -5% deficit to a 2.4% surplus without detriment to GDP growth. In fact, inflation-adjusted (real) GDP growth accelerated from annualized rate of 3% over the prior 8-year period to 3.9% annualized. There are several factors that contributed to this outcome:

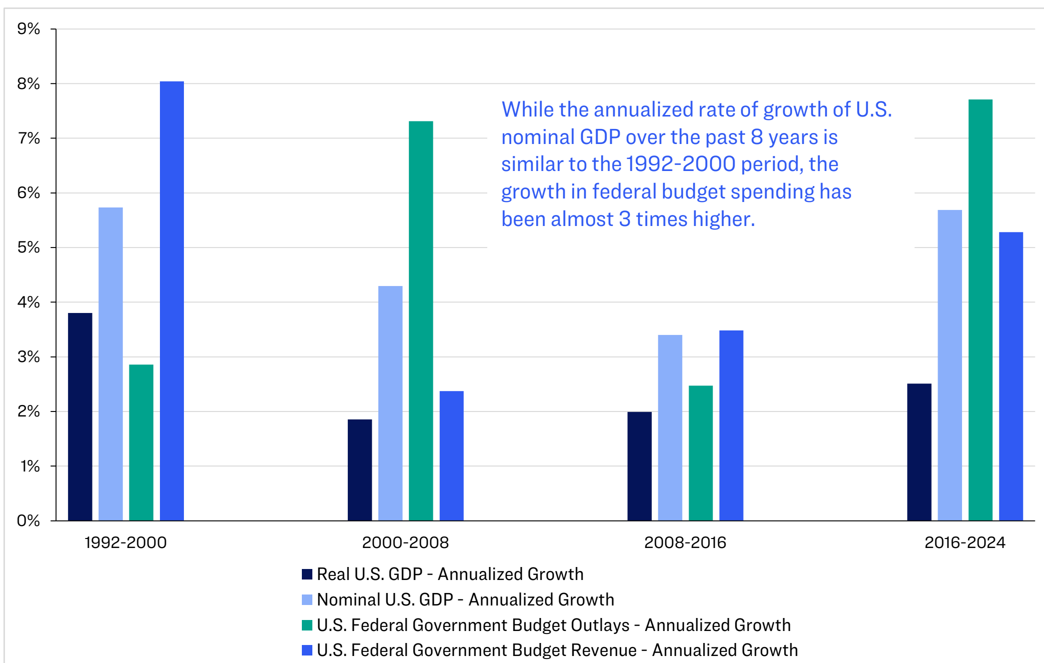
- A combination of faster productivity growth (which accelerated from 2% annualized at the beginning of the first Clinton administration, to 3% annualized during the second one) and robust labor force growth (1.4% per year over the 8-year period) lifted GDP growth,[3] as mentioned above.

- Federal government expenditures grew at an annualized 2.8% pace over the same 8-year period, which was slower than the 5.7% annualized nominal GDP growth. National defense spending shrunk by almost 4% in dollar terms, and by nearly 2 percentage points as a share of GDP, dropping from 4.5% to 2.8%. Additionally, while "mandatory"[4] spending (including net interests paid on outstanding debt) increased between 1992 and 2000, the 4% annualized pace was manageable, particularly thanks to a very modest annual increase in interest expenses of 1.3%. As a result, budget outlays as a percentage of GDP declined by 4.3% during the Clinton presidency (down from 21.4% to 17.1%).

- Among other sweeping changes to the Tax Code contained in the Omnibus Budget Reconciliation Act of 1993, the top individual tax rate was raised from 31% to 39.6%, and higher tax brackets were created for corporate income. As a result, individual and corporate income tax revenues increased from 8.6% to 11.7% of GDP, and total federal revenue as a percentage of GDP rose from 16.3% to 19.5%.

FIGURE 4

Economic and federal budget growth rates over different 8-year cycles.



Source: Bureau of Economic Analysis, U.S. Treasury, TIAA Wealth Chief Investment Office.

[3] Productivity growth and labor force growth are the two key drivers of long-term economic growth.

[4] Spending on certain programs that are required by law. Examples are Medicare, Medicaid, Social Security. While net interest payments are usually categorized independently, we view them as another mandatory expenditure.

The key question to ask now: can this success be replicated today? While we think there are reasons to be optimistic that GDP growth could be higher than what is assumed by the CBO in its baseline projections (average nominal GDP growth of 3.9% over the next decade, similar to the 2009-2019 trend), current fiscal dynamics present a more challenging backdrop (Figure 4).

- While income and corporate tax rates increased in 1993, President Trump's economic agenda envisions an extension of the tax cuts passed under the 2017 TCJA, a further reduction in the corporate tax rate, and other tax cuts. In this scenario and based on historical precedents, it could therefore be difficult to increase tax revenue significantly as a percentage of GDP from current levels (Figure 5).

- On the spending front, the House budget resolution is centered around up to $2 trillion in spending cuts. However, questions abound as to what categories of federal expenditures will be targeted. "Mandatory" categories like Social Security, Medicare and Medicaid, Income Security, and interest payments account for approximately 77% of total government outlays. Cutting some of these programs could have non-negligible implications on economic growth, given their importance for a large subset of the U.S. population and their material fiscal multipliers (Figure 2, again).

- In addition, interest payments are on an upward trajectory due to a feedback loop whereby higher levels of debt lead to larger interest expenditures, a bigger budget deficit and therefore even higher levels of debt. Interrupting this cycle is crucial, and unfortunately interest rates are not helping. While the yield on the 10-year Treasury note declined from 6.7% to 5.1% between 1992 and 2000, it has risen from 1.5% to 4.3% since the end of 2021, and it could be difficult to achieve much lower average levels of interest rates over the long term if both productivity and price inflation continue to grow at a 2% pace or faster.

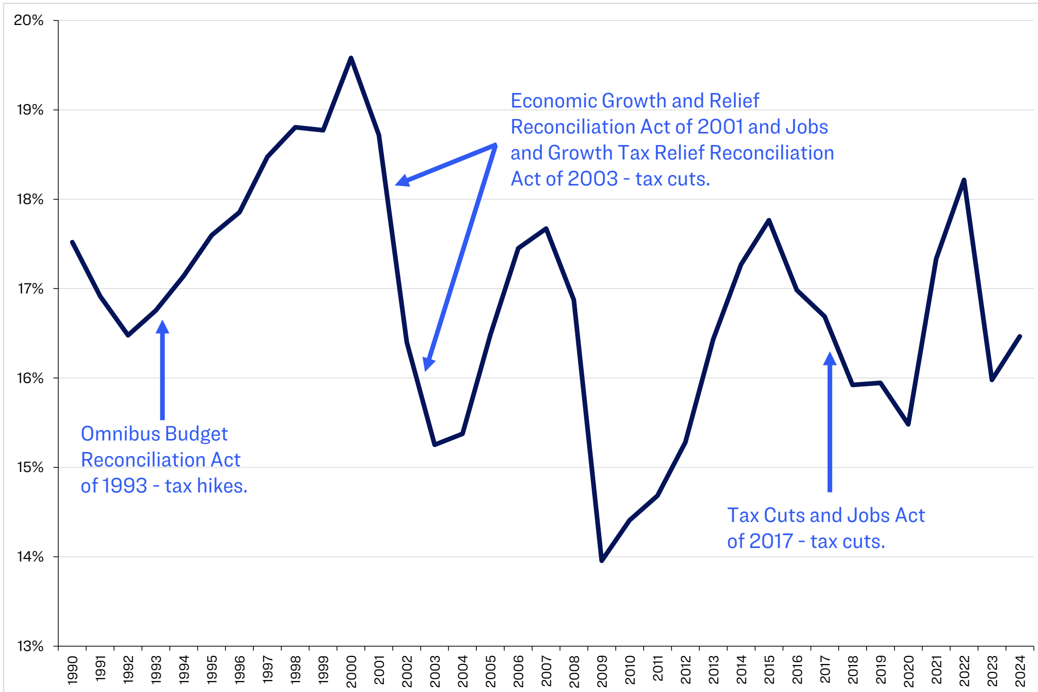
- What about economic growth? The labor force has grown at a 1.2% annualized rate since 2021, which is well above the 0.7% pace observed between 2010 and 2019 and not far from the 1.4% pace between 1992 and 2000. However, 55% of the increase in the labor force since 2021 is attributed to foreign-born individuals. Therefore, an aging population coupled with stricter immigration policies could moderate labor force growth, reducing the positive impact on economic growth.

- On the other hand, the ingredients required for a continued improvement in productivity growth are manifold: evidence of strong new business start-ups, growing adoption of artificial intelligence (AI) technologies across industries, and prospects for increased government deregulation. In addition, both secular and cyclical factors could keep inflation higher than the 2010 decade (when the year-over-year growth in PCE inflation averaged only 1.4%) and closer to the levels that prevailed in the 1990s (2.3%).

- If both productivity and inflation growth rates can sustainably return to 1990s levels, nominal GDP growth should also increase from the 4% average run rate observed between 2009 and 2019. This result would be a positive development for the long-term trajectory of the U.S. budget deficit and national debt.

FIGURE 5

Federal revenue as a percentage of GDP.



Source: U.S. Treasury, TIAA Wealth Chief Investment Office.

Is government spending already slowing?

Despite the intensifying political clamoring around the requirement to curb budget spending, fiscal outlays by the U.S. Treasury are marginally higher than they were one year ago. The U.S. Treasury publishes a detailed daily bulletin reporting expenditures and revenues by category, which shows that rather than moderating, total budget outlays since the beginning of the fiscal year (October 1, 2024) have been tracking a little higher than the same period over the previous fiscal year. In particular, benefit payments to the Social Security Agency are up 14% year-over-year, while interest payments on Treasury securities are up 19%. These are both “mandatory” items, and as we discuss above, their steady increase complicates any effort to reduce the budget deficit.

Conclusions

A smaller budget deficit (approximately 7% of GDP currently) is key to stabilizing the upward trend in the debt-to-GDP ratio, and the importance of achieving this outcome is garnering growing consensus among political circles. Our view is that the combination of higher productivity and price inflation growth rates could boost nominal GDP growth and therefore contribute to this process. However, swelling “mandatory” expenditures and the ongoing focus on additional tax cuts represent very challenging headwinds to any meaningful improvement in the federal government’s fiscal position. As a result, any attempt to address the budget imbalance could prove fleeting without long-term solutions aimed at reining in “mandatory” spending or increasing revenues. These solutions could represent a drag on economic growth in the near term. They would also be very unpopular and would therefore require strong and bipartisan willingness to act within the government.

Financial markets have seemingly become more worried about the Trump administration’s stated goal of reducing the budget deficit to 3% of GDP. Spending cuts focused on federal programs like Medicaid and food stamps could exert some downward pressure on economic growth, if they materialize. In this environment, economic uncertainty and market volatility may remain elevated, therefore reducing the risk of significantly higher long-term bond yields, which should support the attractiveness of high-quality fixed income securities. As a result, we continue to believe that investors are better served by remaining diversified within and across asset classes.

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