
Fixing America's Finances: The Rub on Reducing Federal Spending

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For the better part of six decades, the U.S. government, like a household that regularly fails to balance its budget, has spent more than it earns. The Trump administration has wasted no time trying to rein in federal spending through a downsizing of the federal workforce and other headline-grabbing moves.

But making meaningful spending cuts will be an uphill battle, both in the short and long term. In this week's Markets in a Minute, we take a look at the challenge of lowering federal spending, and why it matters even more than just a few years ago.

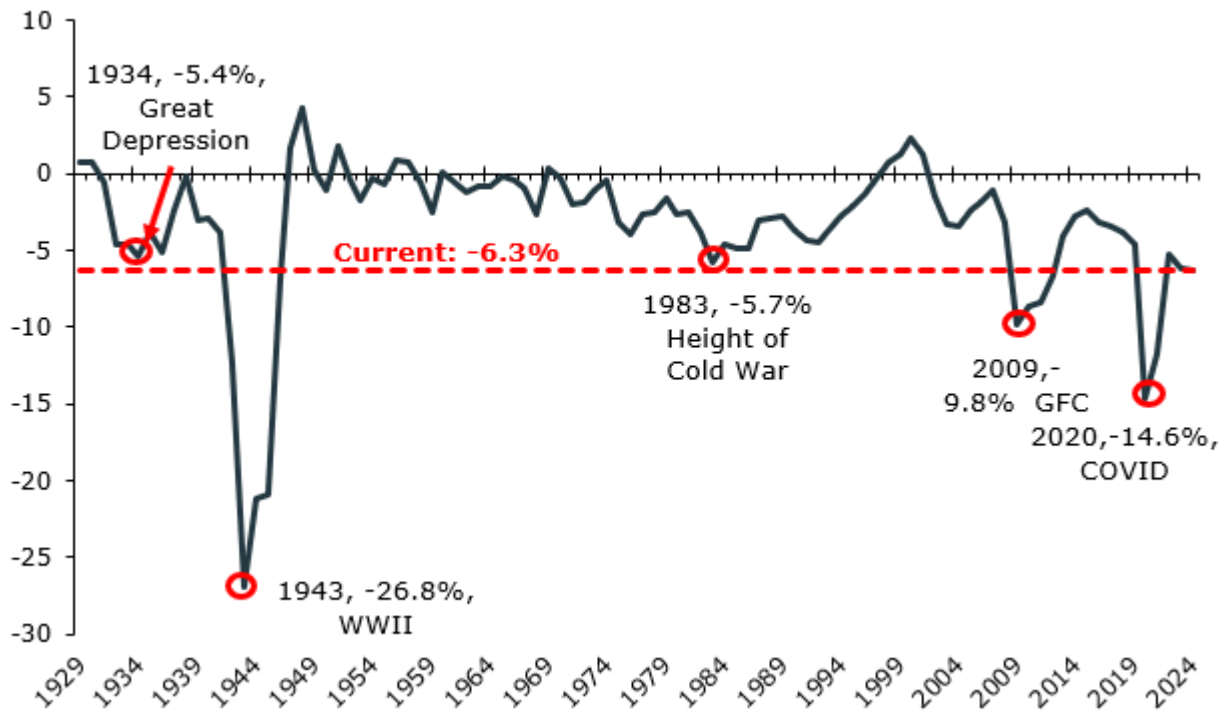
Back to the Future

When the federal government spends more than it collects in taxes and other revenue, it must borrow to cover the gap, or the deficit.

With the exception of select years, the U.S. has run a deficit since 1960, particularly during national crises. The deficit widened significantly during the Global Financial Crisis and the pandemic, when the federal government unleashed massive stimulus spending and tax revenue plunged.

While we've seen some improvement since those crises, the deficit remains wide on a historical basis. Today, it's almost double its long-term average and nearly equivalent to where it stood at the height of the Cold War in 1983.

United States Deficit / Surplus (% of GDP)



Source: Kestra Investment Management with data from FRED. Data from 1929-2024

The Price of Overspending

Recurring deficits have come at a steep cost. Government borrowing to cover yearly budget holes has fueled a dramatic increase in our national debt, both on a relative and absolute basis. In fiscal 2024, [the national debt](#) topped 120% of gross domestic product (GDP), nearly double what it averaged between 1940 and 2023. (See [how the U.S. compares](#) to other countries on debt to GDP, an indicator of a nation's ability to repay its debt.)

What are the opportunities to make meaningful spending cuts or other reforms? As a starting point, it helps to understand how we, as a country, spend most of our money.

The Elephant in the Room: Mandatory Spending

The cost of entitlement programs, including Medicare, Medicaid and Social Security, represents a whopping two-thirds of the federal budget. Stated differently, 83% of every dollar the government collects is spent on these programs.

The aging of the U.S. population, or the so-called [Silver Tsunami](#), has been a major driver of spending on Medicare and Social Security and is expected to put a bigger strain on these programs. [Immigration policy](#) will also impact their financial health since it affects the supply of younger workers who can pay into them.

The conversation around reforming entitlement programs is starting to change, but, generally speaking, both parties have [consistently said](#) they don't plan to touch the programs, particularly Medicare and Social Security.

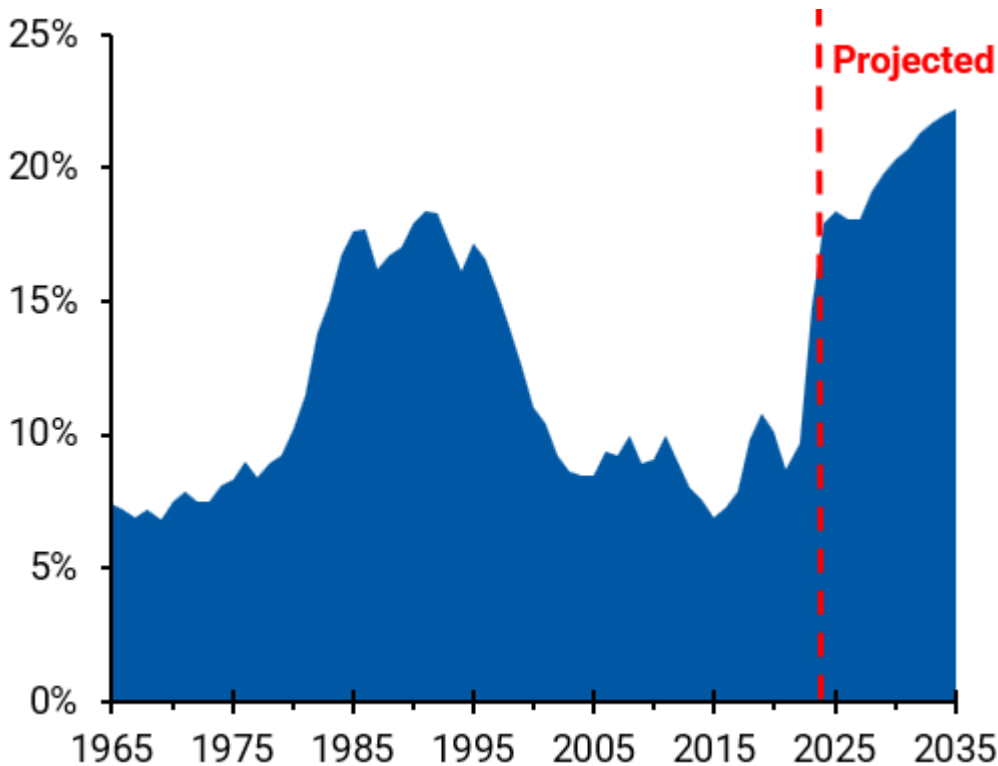
Interest on the National Debt

For the last 20 years, interest costs on the national debt declined even as overall spending grew. So, in a sense, it didn't matter that we kept borrowing greater amounts to cover yearly deficits. But now that rates are higher – and the [near-term prospects](#) for Fed rate cuts have diminished – the surging cost of servicing the national debt is quickly becoming a

difficult problem to manage.

Interest expense as a percentage of federal revenue was 18% in 2024, nearly double what it was in 2020. In fiscal 2024, the federal government **spent more** on interest costs than it did on defense or Medicare. Defense spending, by the way, is the **largest single category** of discretionary spending and is also likely to go untouched because of growing geopolitical risks and other factors. In addition, defense spending accounts for just under 4% of GDP—the lowest level since 1947—making further cuts unlikely.

Interest Expense as a % of Federal Revenues



Source: Kestra Investment Management and Peter G. Foundation with data from Congressional Budget Office and Office Management and Budget. Data as of January 22, 2025. Projections may not come to pass.

The Trump Plan: Less Spending, Faster Growth

The Trump administration aims to reduce the deficit to 3% of GDP (roughly half of where it stands today) through a combination of cost-cutting measures and pro-growth strategies, including deregulation, tax reform and stimulating energy production. The plan hinges on hitting what may prove to be **ambitious targets**, including reaching a sustained 3% GDP annual growth rate.

In the meantime, President Trump's **Department of Government Efficiency** (DOGE), tasked with cutting spending, has garnered headlines and political pushback for its efforts to shrink the federal workforce, cancel contracts and more. That said, from a budgetary perspective, DOGE can only do so much. The scope of its work is limited to non-defense discretionary spending, which represents only about 14% of the federal budget.

The Budget and the Market

Federal budget negotiations are also front and center. Last week, President Trump signed a continuing resolution to extend the government's budget through the end of September. Still, lawmakers appear a long way off from consensus for a longer-term solution.

As the process unfolded, the stock market shrugged off the budget negotiations. Right now, investors are far more

preoccupied by the fledgling [trade war](#), inflation and other issues with shorter-term economic implications.

Indeed, addressing government overspending and borrowing won't be a quick or easy process. But it's worth doing thoughtfully. As I've noted [before](#), it's an American problem, not a party problem.

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