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Budget cuts and the debt ceiling

If we slash trillions from the federal budget, what does that do to our GDP?

The summer of discontent stretches on. As of this writing, there is a tentative deal. However, the possibility of default is still in play. Republican leaders want major cuts to entitlement programs as a condition of raising the debt ceiling; Democrats agree on the necessity of cuts but also want tax hikes for the wealthiest Americans to bring in added revenue.

A trillion-dollar divide. On July 14, CNBC.com reported that both parties had tentatively agreed on nearly $1.4 trillion worth of reductions to the federal budget. That's not too surprising: $1.4 trillion is the projected size of the budget gap for the fiscal year ending in September. Republicans have called for $2.4 trillion in cuts.

This federal belt-tightening is going to lead politicians, economists and consumers into the second part of the debt cap conversation. Two very important questions demand our attention.

If we cut trillions from the federal budget, how will that affect GDP? In fiscal year 2009, federal spending represented 24.7% of U.S. gross domestic product. The percentages haven't been this high since 1946. The Office of Management and Budget thinks that federal spending will average about 23% of GDP between here and 2020; the Congressional Budget Office thinks the percentage will be slightly greater. It's worth noting that the federal government has only gathered (on average) 18.5% of GDP in tax revenues annually across the past 30 years.

If the economy wanes, what happens to stocks? The mood on Wall Street doesn't always correspond to the mood on Main Street, but this much is certain: pre-retirees can't stomach another stock market downturn. Investors who are a decade or less from their envisioned retirement dates cannot imagine pushing back retirements even further. Recently, the mood on Wall Street has been cautiously bullish - but if the bulls bolt thinking that the economy is stagnating or sliding back into recession, the near future may call for some active or tactical portfolio management.

Let's hope the "what if" stays hypothetical. What if no deal is reached by the August 2 deadline set by the Treasury Department? The Bipartisan Policy Center forecasts that the federal government would have to spend $134 billion less than planned during the rest of the month. So $134 billion would be removed from the U.S. economy in 29 days. This is more than 10% of America's monthly GDP. Imagine that happening for a start, and then factor in a 9% jobless rate and the possibility of a stock market swoon and higher interest rates. It is not a pretty scenario, and it is one the U.S. will hopefully avoid.

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