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Economic Briefing

US government finances – tariffs and savings will not rescue the day

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Congress is currently negotiating a major fiscal package that would further inflate the US deficit in the coming years. This would cause the debt ratio to rise sharply and call into question the long-term sustainability of US public finances. At the same time, the rating agency Moody's has downgraded the credit rating of the US. We analyze the extent to which tariff increases and spending cuts can improve the financial situation.

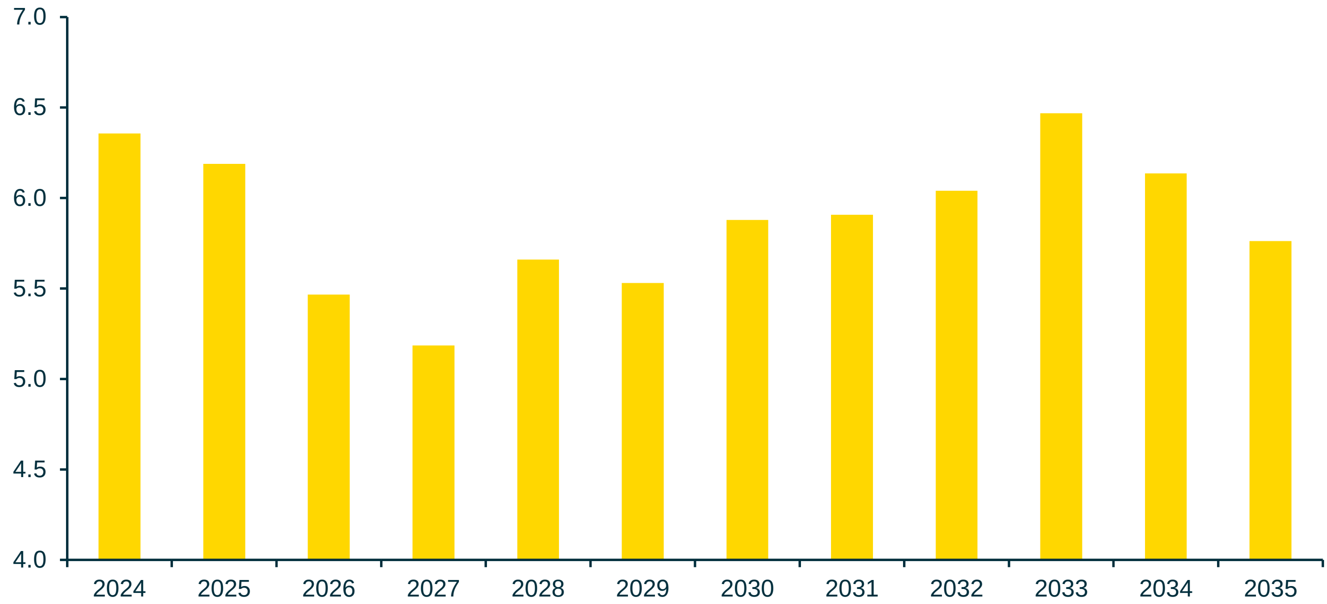
The baseline is already worrying...

Based on current law, the Congressional Budget Office (CBO) estimates that the US federal government's deficit will average around 6% of GDP over the next ten years, meaning that it will not decrease significantly (Chart 1).

The debt ratio will exceed the high of 106% of GDP reached at the end of World War II in just a few years and will be almost 119% of GDP in 2035.

Chart 1 - The budget baseline is bad enough

US federal government deficit, after 2024 CBO projection based on current law, fiscal years



Source: CBO, Commerzbank Research

... and Congress is working on even higher deficits

The “big beautiful package” demanded by President Trump has cleared its first hurdle in the House of Representatives. At its core is an extension of the income tax cuts implemented in 2017 (without legislative action, tax rates would otherwise automatically revert to their previous, higher levels), further relief promised during the election campaign (e.g., tax deductibility of interest on car loans) and very few savings. Based on calculations by the Joint Committee on Taxation, we estimate that this package would increase the deficit (including interest) by USD 3.5 trillion over the 10-year period relevant for budget planning (2026-35), or around 1% of GDP on average per year. Incidentally, this is the best-case scenario. The fiscal package provides for many of the relief measures to expire in 2028 or 2029, a common trick to conceal the realistic costs of a fiscal package. Experience suggests that Congress is likely to extend temporary tax breaks before they expire. In general, it seems problematic that relief appears front-loaded while burdens are back-loaded (i.e., after the 2028 election).

How can the hole be plugged?

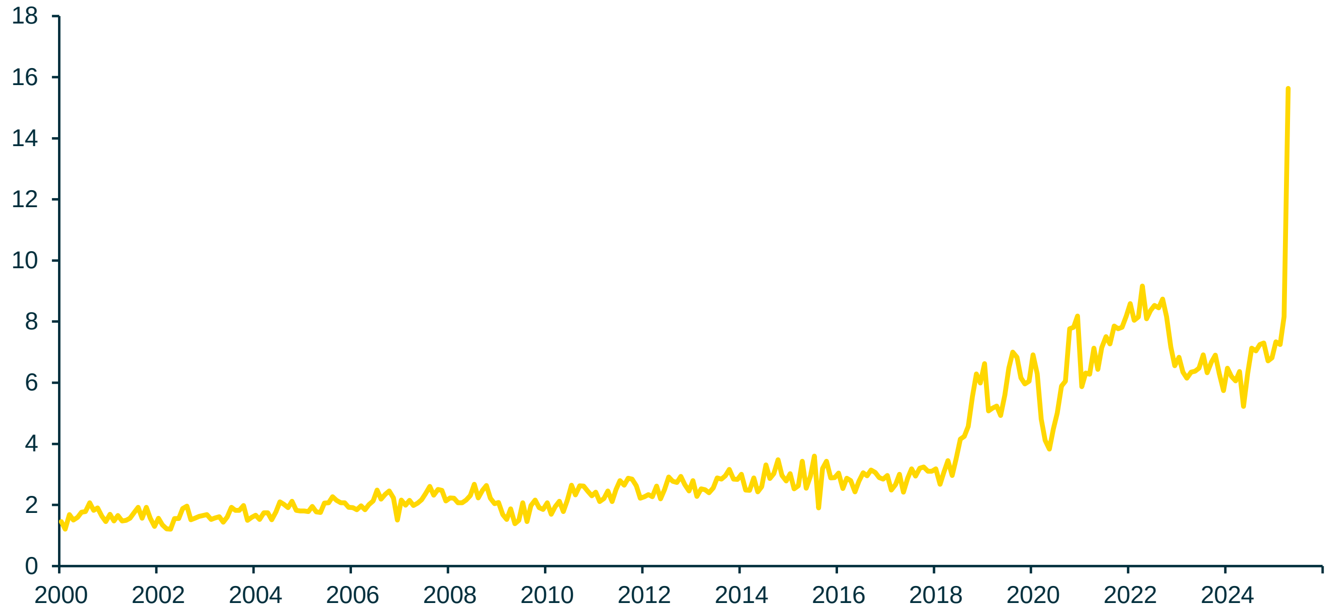
The government has promised to reduce the deficit despite the tax cuts. Treasury secretary Bessent has indicated a deficit of 3% of GDP in the medium term. To achieve this, other government revenues would have to be increased – or spending significantly reduced. What are the chances of this happening?

President Trump believes that tariffs will generate enormous revenues, which will then also be paid by foreigners.

In fact, government tariff revenues nearly doubled to $15.6 billion in April, the first month in which the tariff increases fully took effect (Chart 2). On average, the US government collected only $6.6 billion in tariffs per month in 2024.

Chart 2 - US tariff receipts are rising steeply

US federal government's monthly tariff receipts (net, i.e. after refunds), in billion dollars



Source: US Treasury, S&P Global, Commerzbank Research

However, extrapolated over a year, April's revenues would only amount to just under $200 billion. This would be only be roughly $100 billion more than in 2024. How high the tariff revenues will ultimately be also depends on how strongly imports react to the tariffs.

White House trade adviser Peter Navarro had originally predicted annual tariff revenues of $600 billion. This is probably based on a static analysis: with last year's imports of $3.3 trillion, an average tariff rate of just under 20% would generate this amount. However, this is a naive calculation. After all, imports would become considerably more expensive due to tariffs, causing demand for foreign goods to collapse. The Tax Foundation think tank therefore expects tariff revenues of only $140 billion, the Yale Budget Lab $180 billion, and the Penn Wharton model $290 billion.

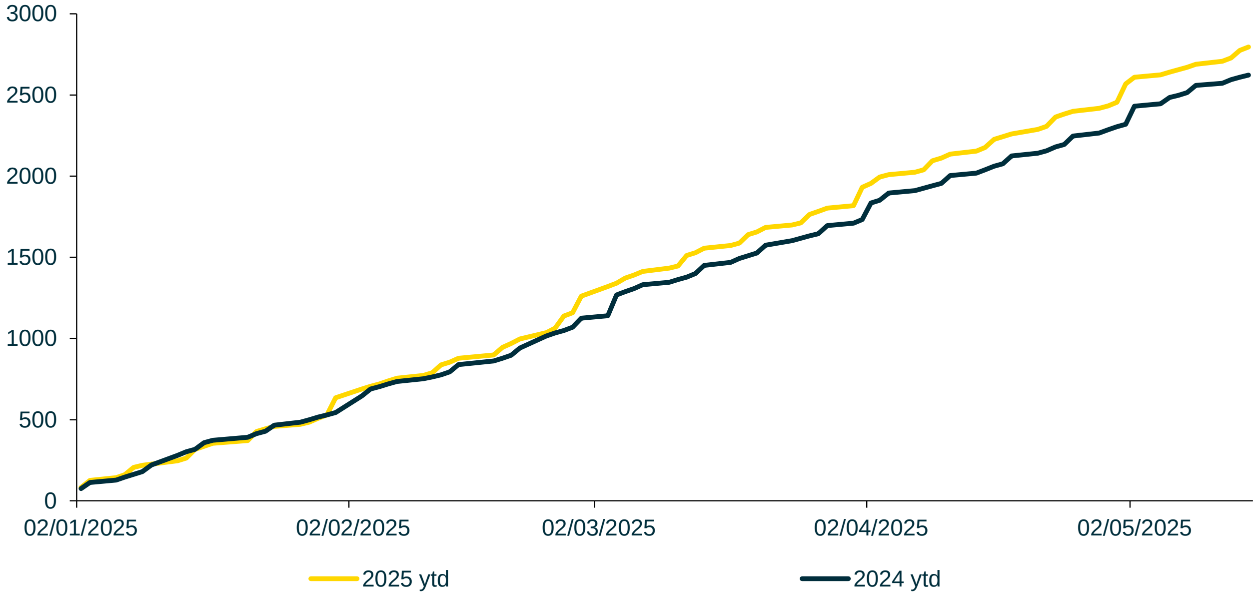
Based on historical demand elasticities, we have **estimated** that US imports are likely to be 40% lower after four years than they would be without the tariffs. Assuming that imports would grow moderately each year without tariffs, a decline of around 30% compared with 2024 to around $2.3 trillion would be realistic, which would result in tariff revenues of around $450 billion. However, it should be noted that tariffs dampen growth and lead to lower corporate profits to the extent that they are borne by US companies. Tax revenues should therefore be lower. The net effect on public finances would thus be smaller. Ultimately, additional annual revenues of $200 billion at best seem realistic.

Spending cuts by DOGE?

Alternatively, the holes could also be plugged by spending cuts. The Department of Government Efficiency (DOGE) is attempting to do this, but with little success so far. The federal government is spending more money this year than last year (Chart 3). This is sobering, even if some measures have not yet had an impact on cash flow because, for example, employees who are leaving the government will continue to receive their salaries for a certain period of time.

Chart 3 - No savings so far

expenditures excluding interest, year-to-date, in USD bn

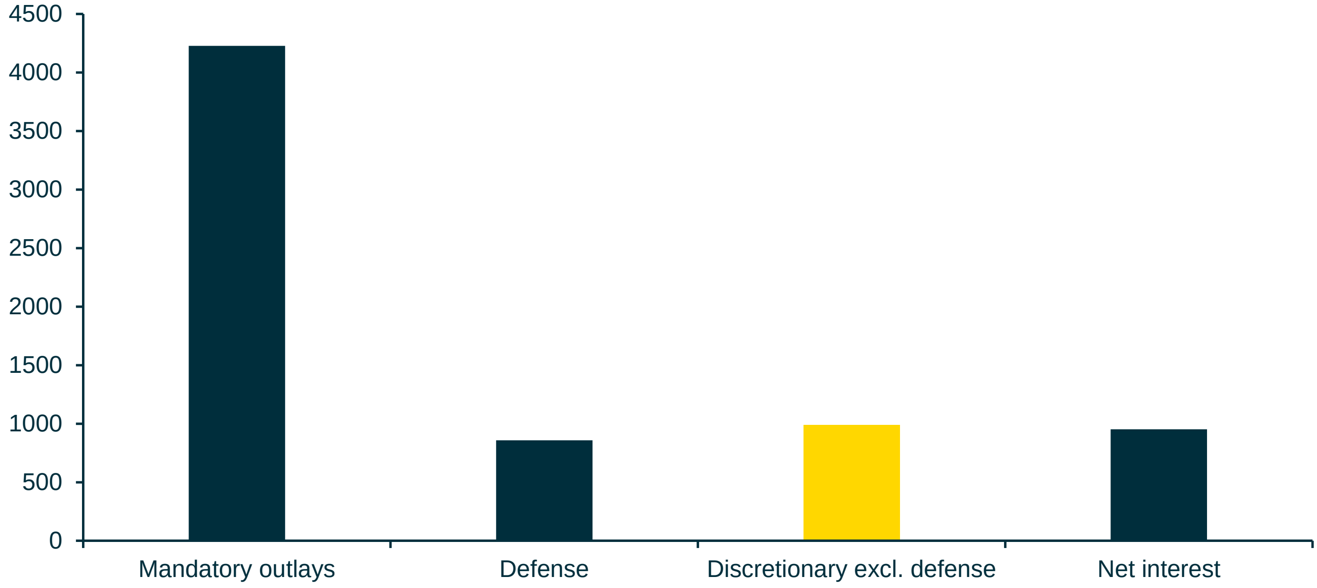


Source: US Treasury, Bloomberg, Commerzbank Research

Despite a current budget of $7 trillion, major savings are proving difficult anyway. A large portion of the budget is spent on social security and health insurance benefits. These are based on legal entitlements (and are thus termed "mandatory" in fiscal policy) and are very popular with the population. Any cuts in this area are a political minefield. This means that over $4 trillion in spending is off limits for savings from the outset. Interest expenditure ($1 trillion) cannot be changed either, and in the current foreign policy environment, cuts in defense ($0.9 trillion) seem unlikely. This means that cutback plans are essentially focused on the remaining expenditure of around $1 trillion (the yellow bar in Chart 4). Even if an aggressive approach is taken, only $100 billion per year is realistic.

Chart 4 - A budget of 7 trillion $ - but where to cut?

Outlays in fiscal 2025 in billion dollars, CBO baseline projection



Source: CBO, Commerzbank Research

Fiscal path still not sustainable

Overall, the additional revenue from customs duties, combined with spending cuts, could be sufficient to finance the upcoming fiscal package. This would essentially keep the country on its old deficit path. However, even the current path of US fiscal policy will drive the debt ratio ever higher and is therefore not sustainable. The financial situation therefore appears to be precarious. The greatest risk is that a new recession will hit at some point in the next few years [1] and fiscal policy will no longer have any buffer to mitigate its impact through expansionary measures. The budget situation could also be exacerbated by interest rates being higher than expected in the coming years. The CBO assumes an average 10-year interest rate of 3.9% for 2026-35. By way of comparison, the yield on 10-year Treasuries is currently just under 4.6%.

[1] The last recession ended in April 2020, about five years ago. The last three expansions lasted between six and ten years. (back to text)

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