JOINT ECONOMIC COMMITTEE
ROBERT F. BENNETT, CHAIRMAN JULY 23, 2003

UNDERSTANDING TODAY'S DEFICITS

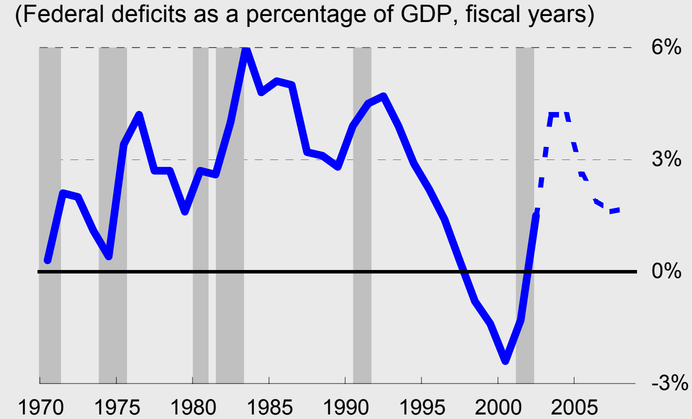
Recent projections of the federal budget deficit – $455 billion this year and $475 billion in fiscal year 2004 according to the Office of Management and Budget (OMB) – have rekindled concerns about U.S. fiscal policy. These concerns are justified because continued increases in the deficit could pose significant economic problems in the future, but they must be tempered with an understanding of how these deficits arose and how the U.S. can rebound from them. The rapid improvement in the U.S. fiscal position in the late 1990s demonstrates that a combination of strong economic growth and modest spending restraint can return the budget to balance. A similar prescription applies today.

Highlights

- **Deficits should be measured relative to the size of the economy**. To compare deficits across years, it is important to account for the economy's capacity to absorb the deficits and the government's ability to finance them. Both of these factors depend on the size of the economy.

- **Today's deficits are still below the peaks of the 1980s and 1990s**, when measured as a percentage of the gross domestic product (GDP).

- **Deficits expand following recessions**. The deficit increased to 6 percent of GDP following the recessions of the early 1980s and to almost 5 percent of GDP following the recession of the early 1990s. Following the 2001 recession, today's smaller deficits continue this pattern.



Deficits Expand Following Recessions
(Federal deficits as a percentage of GDP, fiscal years)
Source: Office of Management and Budget
Dashed line is President's budget
Gray bars denote recessions

- **The weak economy and a declining tax base are the primary cause of today's deficits**. OMB estimates that 53 percent of the budget deterioration in fiscal year 2003 has been due to economic weakness, declines in the tax base, and other technical estimate changes. None of these changes is due to legislation.

- **Deficits will increase the publicly held debt, but the debt will remain lower, relative to the size of the economy, than it was a few years ago.** OMB projects that the publicly held debt will rise to about 41 percent of GDP in 2006, before beginning to fall; that ratio was about 43 percent in 1998.

- **Spending restraint and a growing economy are the keys to reducing future deficits.** Indeed, the 1990s demonstrated how these factors – coupled with pro-growth tax relief in the form of reduced capital gains taxes – can rapidly improve the fiscal situation.

Deficits should be measured relative to the size of the economy

This year's deficits will be the largest ever in nominal terms (i.e., in current dollars), but this is not the most meaningful way of characterizing them. To compare deficits across different years, it is important to account for the economy's capacity to absorb the deficits and the government's ability to finance them. Both of these factors depend on the size of the economy. For that reason, the best way to compare deficits across years is to measure them relative to the size of the economy. As shown in Chart 1, the annual budget deficit is projected to be slightly more than 4 percent of gross domestic product (GDP) this year and next. These deficits are not small, but they are lower than many of the deficits experienced in the 1980s and the early 1990s.

Recessions increase deficits

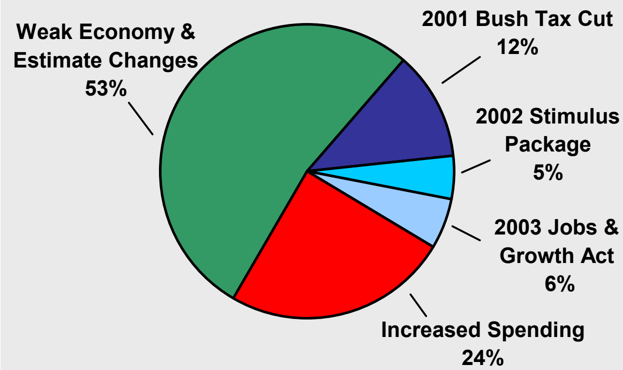
The economy continues to be in a gradual recovery following the recession of 2001. It is common for deficits to increase, often substantially, following periods of economic weakness. As shown in Chart 1, deficits increased substantially during and after each of the last six recessions. For example, the deficit increased to 6 percent of GDP following the recessions of the early 1980s and increased to almost 5 percent of GDP following the recession of the early 1990s. Today's somewhat smaller deficits continue this pattern.

The deficits were caused by a "perfect storm"

Some observers argue that the tax relief packages of the last three years are the primary reason that budget deficits have replaced surpluses. This is incorrect. In fact, the large deficits reflect the near "perfect storm" that has rocked the federal government's budget: 1) revenues plummeted due to a weak economy and a sharp drop in the stock market, 2) spending increased due to two wars and new homeland security requirements, and 3) fiscal discipline weakened following the emergence of budget surpluses. These factors account for about three-quarters of the decline in the budget surplus.

What Happened to the Surplus? 2

Changes to the FY2003 budget forecast from April 2001 to July 2003



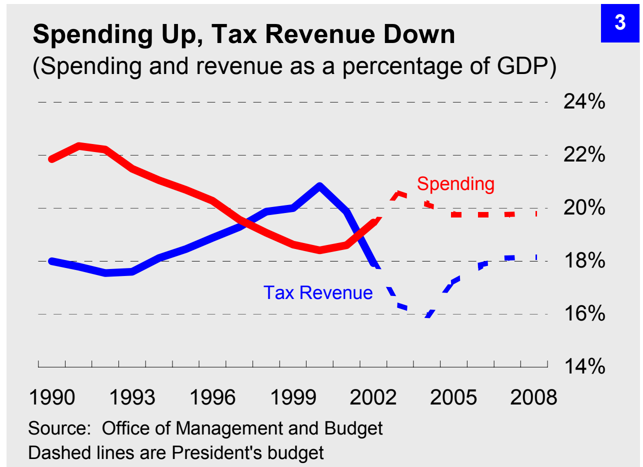
Source: Office of Management and Budget

April 2001 was the high point for budget surplus forecasts. OMB then estimated a $334 billion surplus for fiscal year 2003, while it now estimates a $455 billion deficit. As shown in Chart 2, economic changes have been the primary cause of the budget deterioration in the current fiscal year. The weak economy reduced the size of the tax base, increased spending on programs like Medicaid, and revealed technical adjustments that needed to be made to the budget estimates. In all, those factors account for 53 percent of the changes in OMB's projections, and none of them were due to legislation. Legislated spending increases and tax relief account for 24 percent and 23 percent of the reductions in OMB's projections, respectively (increased debt service costs have been allocated to each category). Estimates for other years by both OMB and the Congressional Budget Office (CBO) reveal a similar trend.

Revenues have declined sharply, primarily because of the weak economy

Tax revenues have declined dramatically in recent years. In nominal dollar terms, revenues have now dropped for three straight years, a modern record. In fiscal year 2003, tax revenues are now estimated to be $269 billion, or 13 percent, below the level in 2000. This year's revenues would be below those of 2000 regardless of whether the recent tax relief bill had been enacted.

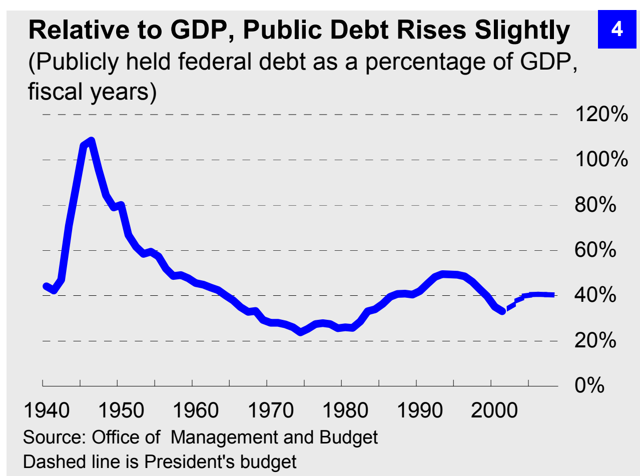
As illustrated in Chart 3, tax revenues are now expected to total 16.3 percent of GDP in the current fiscal year, their lowest level relative to the size of the economy since 1959. Tax revenues spiked up to 20.8 percent of GDP at the end of the technology boom, driven by booms in capital gains, stock options, corporate profits, and other taxable income. In retrospect, these revenues were unsustainable (see, e.g., the CBO study cited below). As the stock market fell and the economy entered recession, revenues declined significantly. About two-thirds of the revenue decline, relative to expectations, was due to economic weakness and declines in the tax base; only a third of the decline was caused by recent tax relief legislation.



The current decline in tax revenues to 16.3 percent of GDP will likely prove to be just as ephemeral as the spike up to 20.8 percent. Lower taxes do provide a welcome boost to the U.S. economy. However, the tax system is structured so that tax revenues will grow faster than the economy. OMB projects that under the president's budget tax revenues will rebound to 18 percent of GDP – their average level over the last 40 years – and beyond in coming years.

Today's deficits will not dramatically increase the publicly held debt

The publicly held debt is the amount of money the federal government has borrowed from the public; it is essentially the sum of all previous annual budget deficits and surpluses.



OMB projects that under the president's budget publicly held debt will increase to 40.6 percent of GDP in 2006, after which a growing economy and declining budget deficits will reduce that ratio slightly to 40.5 percent in 2007 and 40.3 percent in 2008 (see Chart 4). Although the increase in the debt-to-GDP ratio is unfortunate, it is important to put it into context. The debt was substantially higher, relative to the size of the economy, for most of the 1980s and 1990s. Indeed, the debt amounted to almost 43 percent of GDP as recently as 1998.

Returning to budget balance requires economic growth and spending restraint

The two keys to balancing the budget are resumed economic growth and spending restraint. As noted above, resumed economic growth will naturally lead to increased tax revenues. However, budget balance can be restored only if spending grows more slowly that those burgeoning revenues.

As illustrated in Chart 3, spending has grown significantly faster than the economy since 2000. While spending was only 18 percent of GDP in 2000, it has now risen to more than 20 percent. Some of this increase has been warranted given the triple shocks of war, homeland security, and increased spending due to the recession. As those shocks recede and homeland security becomes integrated in the federal budget, however, the rate of growth in spending can and should decline significantly.

The 1990s demonstrated that pro-growth tax relief – the 1997 reductions in capital gains taxes – can go hand-in-hand with modest spending restraint, a growing economy, and a rapidly improving fiscal situation. A similar prescription applies today. The president and the Congress have enacted significant pro-growth tax relief, and the economy is beginning to show signs of renewed growth. However, it remains to be seen whether the government will demonstrate sufficient spending restraint.

Further Reading about Deficits

Office of Management and Budget, "Mid-Session Review, Fiscal Year 2004," July 2003
(http://www.whitehouse.gov/omb/budget/fy2004/pdf/04MSR.pdf)

Joint Economic Committee, "Economics of the Debt Limit," May 2003
(http://jec.senate.gov/studies/JEC%20on%20debt%20limit.pdf)

Joint Economic Committee, "Deficits, Taxation and Spending," April 2003
(http://www.house.gov/jec/tax/deficits.pdf)

Congressional Budget Office, "Where Did the Revenues Go?", August 2002
(http://www.cbo.gov/showdoc.cfm?index=3662&sequence=0)

> Note: The Congressional Budget Office (http://www.cbo.gov) is set to release its mid-year federal budget review on August 26. The CBO report is expected to be similar to the OMB report.

Recent JEC Publications

- **"Recent Economic Developments: Poised for a Pickup in Growth,"** July 8, 2003.
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  Explains why the program needs market-based reforms to become more financially viable and responsive to patients.

- **"A Primer on Deflation,"** May 21, 2003. Answers basic questions about what deflation is and what it may mean for the U.S. economy.

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