



# Economic Letter

## U.S. Budget Deficits Shrink, but Long-Run Issues Remain

by Jason Saving

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**A** threatened January federal government shutdown was averted when congressional negotiators late last year reached agreement on a two-year budget. The bipartisan accord partially undid forced cuts under “sequestration,”<sup>1</sup> replacing them with an array of smaller spending reductions while adding “revenue enhancements.” The deal is designed to save slightly more money, in a targeted manner, than would have occurred with sequestration over the next 10 years.

The budget is only the second one to have been passed in the last five years and represents to some the resumption of “normal order”—and a possible end to a polarized environment that produced fiscal gridlock and runaway deficits.

These events come on the heels of a less-well-reported but perhaps more significant announcement that the federal deficit fell in 2013 to its lowest level in five years, with still-smaller shortfalls expected in 2014 and 2015. Could it be that the nation’s fiscal house has been put substantially in order, with the country placed on a permanently better fiscal trajectory? Or are recent improvements simply a prelude to future budgetary storms?

### The Budget Deal

To understand the short-run context, one must begin with a brief overview of the

recent budget deal passed by Congress and signed by the president. The budget deal will raise discretionary domestic spending in 2014 and 2015 by a cumulative \$47 billion. It will also boost spending over the ensuing eight years by a total of \$15 billion. These increases will be split evenly between defense and nondefense spending and not—for the most part—dedicated to any specific program.

The front-loaded \$63.2 billion in higher discretionary spending is offset by \$85 billion of cuts, new fees, increased fees and other measures. The main deficit-closing measures involve an extension of sequestration, left in place into fiscal 2022 and 2023, and the introduction of new customs user fees during those years. Together, these measures would reduce expected budget deficits by \$34.8 billion. The deal would also raise \$12.6 billion through higher aviation security fees, \$12.2 billion in net payment reductions to military and civilian government retirees, \$7.9 billion through Pension Benefit Guaranty Corp. premium increases (partly on a per-institution basis and partly based on risk), \$3.2 billion in reduced replenishment of the Strategic Petroleum Reserve and \$1.9 billion in the “prevention of waste, fraud and abuse” in the nation’s welfare system.<sup>2</sup>

Compared with a \$63.2 billion increase in discretionary domestic spending, the overall budget bill is estimated to reduce

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the deficit by \$22.6 billion over the next 10 years—though this does not mean deficits would fall in each year of the deal. On a year-by-year basis, the spending plan increases the deficit by \$23.3 billion in fiscal 2014, by \$18.2 billion in fiscal 2015 and by \$4.2 billion in fiscal 2016 (*Chart 1*). The remaining seven years contain average annual deficit reductions of \$8.2 billion, provided a future Congress does not undo the agreement.

### Short-Term Outlook

Unfortunately, the budget deal does not solve the nation's budget problem. To get a handle on the nation's short-term fiscal situation, it is useful to review a bit of budget history.

Just six years ago, the 2008 deficit totaled \$458.6 billion. While it was the highest ever in dollar terms, as a share of the economy it was only about 1 percentage point above the post-Vietnam average of 2.2 percent (and far below deficits amassed in the 1980s). The best available forecasts called for the dollar amount of the deficit to fall with each passing year, entering surplus by 2012 and remaining there as far as the eye could see.

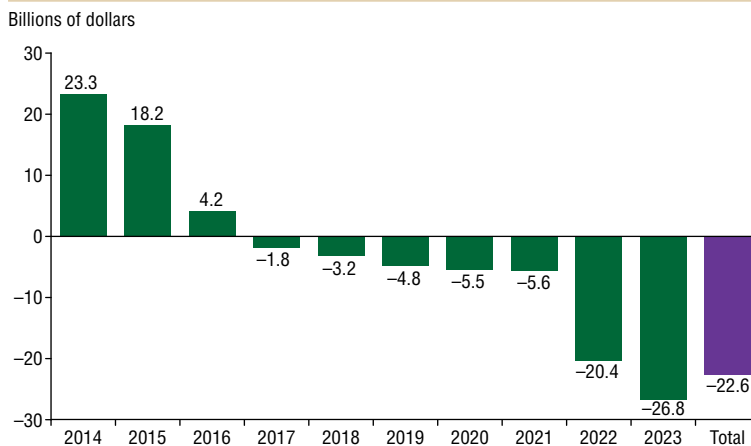
One year later, the picture changed dramatically: The 2009 deficit rose by \$1 trillion to \$1.4 trillion, a record peacetime deficit. It remained above \$1 trillion for each of the next three years: \$1.3 trillion in fiscal 2010, \$1.3 trillion in fiscal 2011 and

\$1.1 trillion in fiscal 2012 (*Chart 2*). Even expressed as a share of the economy, the total federal debt accumulated during that four-year period was the greatest since World War II.

To be sure, economic research generally finds that countries should run deficits when in recession—or when emerging from them. Along with the collapse of financial-lending channels during the Great Recession and inexplicable labor-market sluggishness, a reasonable case could be made that the slow recovery was more closely akin to a recession than an expansion—above-zero gross domestic product (GDP) growth notwithstanding. Nevertheless, the corollary that large deficits should not be incurred during expansions for fear of their eventual economic consequences began taking hold. It was in this context that the 2013 deficit came in at \$680 billion, about half the average of the previous four years.

What caused the 2013 deficit to narrow? One answer is normal cyclical improvement in economic activity. As the economy slowly recovered, more individuals found jobs and firms experienced stronger demand for the goods and services they produce, driving up federal tax revenue. For similar reasons, demands on the federal safety net—jobless benefits, food stamps—diminished, driving down federal spending. Policy adjustments also contributed to the change, including the partial

**Chart 1** Anticipated Impact of Budget Deal on Federal Deficit



SOURCE: Congressional Budget Office.

expiration of the 2001/2003 “Bush tax cuts,” expiration of a 2 percent Social Security payroll tax reduction and, to a lesser degree, the across-the-board spending cuts from sequestration. One other important factor was a yet-to-be-explained slowdown in medical cost growth, which helped hold Medicare and Medicaid spending in check.

Taken together, these factors *should* boost federal revenue and reduce expenditures, at least as a share of the economy—and that is exactly what the data show (*Chart 3*). From a 60-year low of 15.1 percent of GDP in fiscal 2009, federal revenues grew to 16.7 percent in fiscal 2013 and are expected to reach 18 percent—the nation’s long-term historical average—in 2014. Similarly, federal outlays have fallen from a peacetime high of 25.2 percent of GDP in 2009 to 22.7 percent in 2013 and are expected to fall further, to 22 percent in 2014.

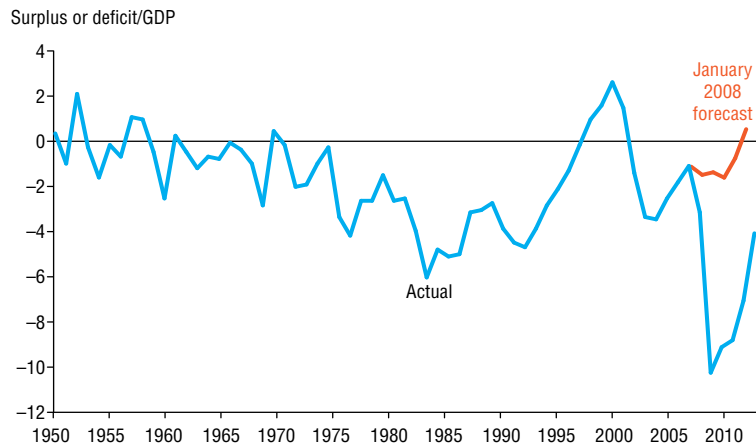
## The Longer-Term Picture

Over the next 10 years, annual deficits might be expected to gradually decline as the recession’s aftereffects increasingly enter the rearview mirror and the “targeted, timely and temporary” short-term stimulus measures intended to combat the recession fade to insignificance.<sup>3</sup> This expectation would certainly be consistent with both 2013’s marked reduced deficit and expected declines in 2014 and 2015. Further, support for this view would be provided by the pickup in revenue from 60-year lows and measures—such as the recent two-year budget agreement—that, at least ostensibly, reduce annual deficits.

However, this outlook turns out not to be the case. After bottoming out at 2 percent of GDP during 2015–18, annual deficits are projected to rise with each succeeding year, reaching nearly 3.5 percent of GDP by 2023. The primary reasons: the retirement of baby boomers, which raises entitlement outlays (Social Security and Medicare), and an expectation that interest rates will rise sharply over the next decade, dramatically increasing U.S. borrowing costs.

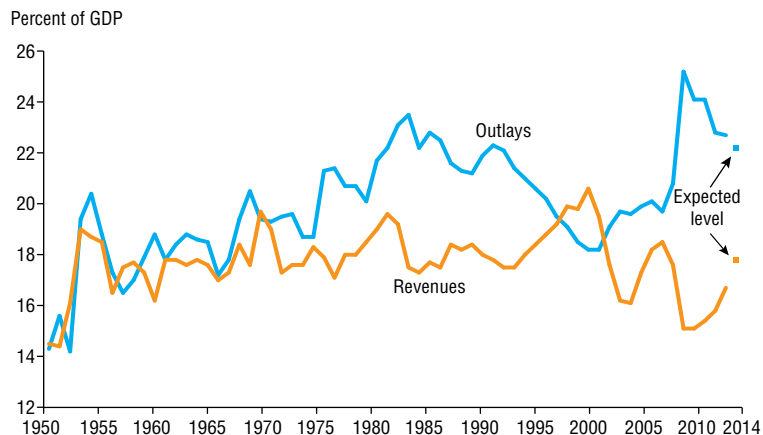
What about further down the road? Under a “current law” scenario (under which Congress makes no adjustments to the existing policy environment), deficits would grow inexorably over time, rising to 6.4 percent in 2038, reaching 14.2 percent

**Chart 2** Budget Deficits Exceed Forecast Levels



SOURCES: Office of Management and Budget; Congressional Budget Office.

**Chart 3** Revenues Near 60-Year Low; Outlays Near 60-Year High



SOURCE: Office of Management and Budget.

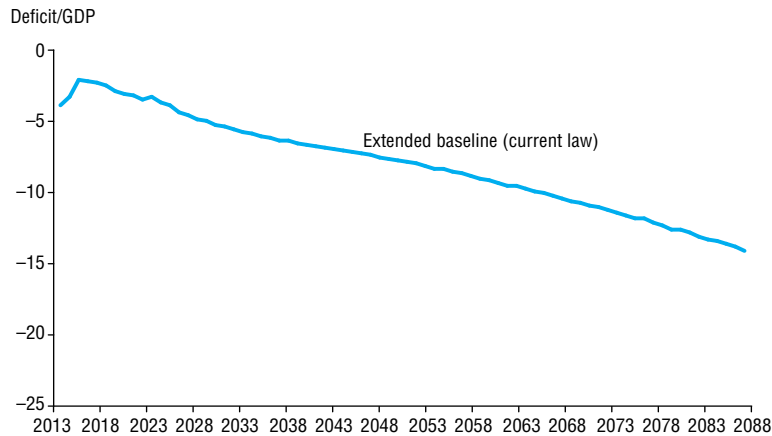
of GDP by 2088 (*Chart 4*). Entitlement spending would grow at roughly the same pace over that period, driven mainly by the interplay of an aging population with ever-more-expensive medical technology. This is no coincidence, because it is precisely this growth in entitlement programs (and to a lesser extent a sizable increase in interest payments) that causes long-term deficits to soar.

The accumulation of historically high federal fiscal deficits over a prolonged period is significant for at least three reasons. First and perhaps most obviously, large and growing deficits directly increase

the interest payments required to service them, requiring sacrifices (or higher taxes) elsewhere. Second, an abundance of economic research illustrates that increased borrowing eventually “crowds out” competing demands for capital from private investment, relegating the economy to a lower growth path. Future generations will face a lower standard of living than they would otherwise experience. Finally, carrying a higher stock of debt makes it more difficult for government to respond appropriately when the next recession occurs. Indeed, this was precisely the situation faced by the U.S. after running historically

## Chart 4

### Long-Term Fiscal Imbalances Remain Unaddressed



SOURCE: Congressional Budget Office.

unprecedented peacetime deficits during 2001–08.

Addressing this issue requires acknowledging two unpleasant fiscal realities. The first is that, while the explosion in short-run deficits over the last few years was driven mainly by temporary phenomena, including poor economic conditions and a deliberate choice to “stimulate” the economy, the long-run situation is caused primarily by a structural imbalance between what entitlement recipients have been promised and the agreed-upon revenues to pay for those promises. The second is that such an imbalance cannot be corrected without cutting spending (including entitlements) or raising taxes.

An often-voiced principle in resolving this dilemma is that government should keep its promises; this principle may be

more difficult to apply than is initially apparent. A decision to spend less means asking entitlement recipients, many of them elderly and on a fixed income, to accept lower benefit checks than they expected. This may well reduce their standard of living, perhaps to unacceptable levels. But taxing more, on the other hand, requires asking working-age citizens to accept a lower after-tax income than they had expected, which reduces the standard of living of both themselves and their dependents.

Deciding who should bear the burden of this fiscal adjustment is difficult, but this does not change the inescapable reality that the burden exists and must be borne by someone. And should that “someone” not be found in the current generation, the burden will be borne by future generations,

whose standard of living will sink lower as a result.

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#### Notes

<sup>1</sup> This is a package of across-the-board spending cuts intended to trim spending by \$1.1 trillion over the next 10 years.

<sup>2</sup> Smaller tax and spending provisions account for the remaining \$12.4 billion.

<sup>3</sup> See “Fiscal Stimulus Issues,” testimony before the U.S. Congress Joint Economic Committee by Lawrence H. Summers, former U.S. Treasury Secretary, Jan. 16, 2008.

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