

Southwest Economy



A Texas Revival

After years of growth that was the envy of most states, the Texas economy has fallen into the pack. Hit hard by the 2001 recession, Texas was thrown off its usual course by a severe downturn in high-technology industries that led to widespread job losses, many in high-paid positions.

Texas emerged from recession in mid-2003, nearly a year and a half after the U.S. economy did. While Texas job growth has begun to accelerate, it remains relatively weak, and a fast-growing industry to propel growth faster than the nation's has yet to step forward.

The Texas economy has been evolving from resource-based industries toward more knowledge-based industries for several decades. If the shrinking influence of the state's energy sector was ever in doubt, those thoughts should be put to rest by the industry's muted response to the recent spike in oil and natural gas prices.

High-tech firms became the important driver of growth in the 1990s, absorbing the state's low-cost real estate and plentiful labor pool. Texas was attractive to firms that wanted to grow quickly, and a new boom was born.¹ But for some reason, many of the industries that grew faster than the

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Five Years of the Euro:
Successes and
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Revising Texas
Economic History*

The Federal Budget: Developments and Outlook

In recent years, concern about the federal budget deficit has become more pronounced and widespread. A combination of economic and policy changes has shifted the budget from surplus to deficit. This shift has probably reduced national saving, which will impose substantial economic costs—a reduction in Americans' future income.

Despite these costs, the budget outlook cannot be described as a crisis. The deficit is still within its historical range. And it is projected to shrink over the next decade, although economic developments and policy changes could slow or reverse the projected decline.

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The Federal Budget: Developments and Outlook

(Continued from front page)

Recent Budgetary Developments Sharp Swing from Surplus to Deficit.

In March, the Congressional Budget Office (CBO) estimated a \$477 billion deficit for fiscal 2004, which began last October. Although CBO has not officially revised its projections, it has announced that fiscal 2004 revenue is running \$30 billion to \$40 billion higher than anticipated, with no change in expected spending. That would put the 2004 deficit at \$437 billion to \$447 billion.

In nominal terms, that would be the largest deficit in U.S. history. That fact, among others, has led to concern about a budget crisis.

It's more reasonable, though, to measure the deficit as a share of GDP. That measure puts the current deficit at about 3.8 percent of GDP, making the picture a little less dramatic (*Chart 1*). Since 1946, the deficit has been larger in eight years (1976, 1982 through 1986, 1991 and 1992) and roughly the same in two others (1990 and 1993).

Still, the recent swing from surplus to deficit has been stunning in both its size and speed. The budget was in surplus from 1998 through 2001, with the surplus peaking at 2.4 percent of GDP in 2000. Over the past four years, the budgetary position has shifted by more than 6 percentage points.

Deterioration in Budget Outlook.

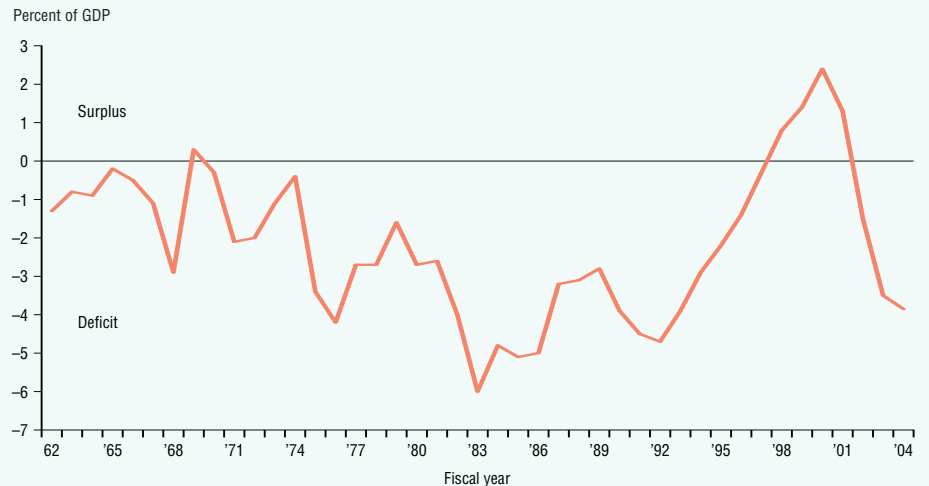
Chart 2 provides another perspective on recent developments—it compares the actual path of the budget with the path projected in CBO's January 2001 baseline. Today's deficit of 3.8 percent of GDP contrasts sharply with the 3.3 percent *surplus* projected then. CBO's March 2004 baseline, discussed further below, is also much less favorable than the baseline from three years ago.

A combination of factors changed the 2004 surplus projected three years ago into the deficit we now observe. About 40 percent of the change is due to economic factors CBO did not predict. The largest economic changes were the 2001 recession and the stock market slump, which lowered federal revenue.¹

Policy changes accounted for the

Chart 1

Sharp Swing from Surplus to Deficit



SOURCE: Congressional Budget Office.

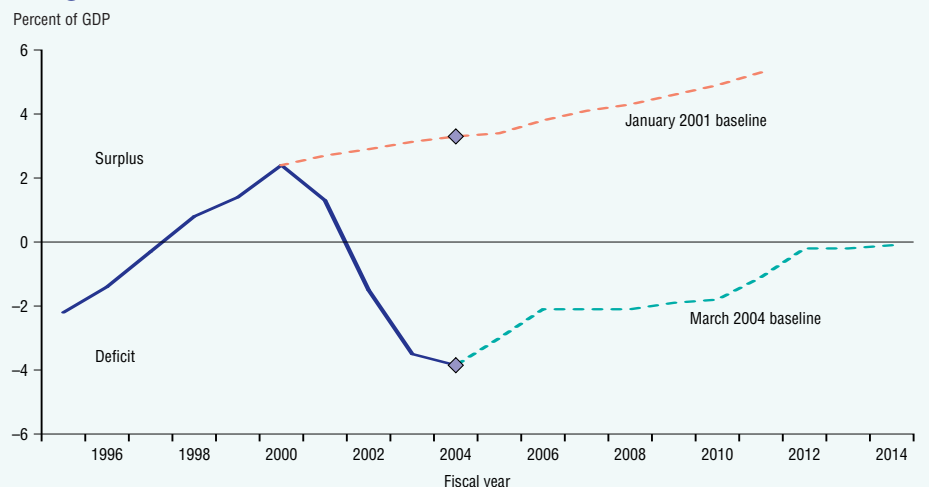
other 60 percent of the deterioration. The January 2001 baseline was CBO's prediction of what would happen to the deficit if the laws and policies then in place remained unchanged. But Congress and the president actually made policy changes that enlarged the deficit. Those policy changes were split

about equally between spending increases (27 percent) and tax cuts (33 percent).²

The spending increases have primarily been in discretionary programs—those whose funding levels are set annually by Congress in appropriation bills. About half of discretionary spending goes to defense and about half to non-

Chart 2

Budget Outlook Has Deteriorated Since 2001

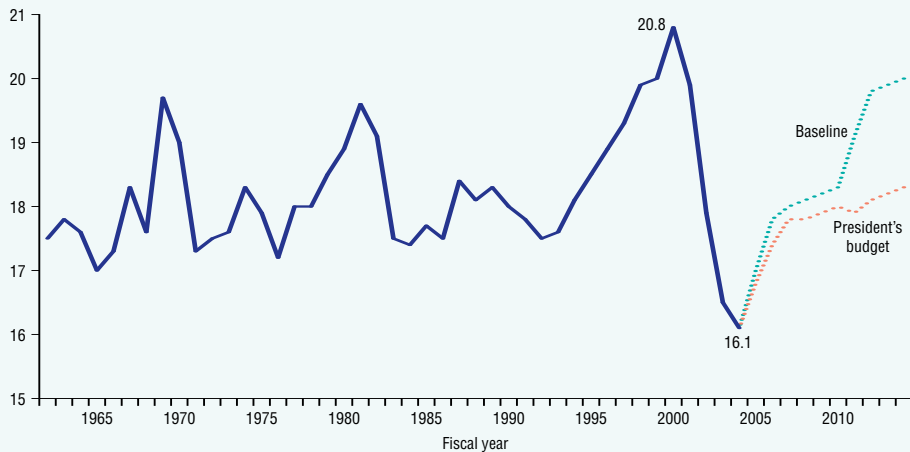


SOURCE: Congressional Budget Office.

Chart 3

Revenue Share Falls from Historic High to Historic Low

Percent of GDP



SOURCE: Congressional Budget Office.

defense programs. The 2001 baseline assumed that discretionary spending would stay at its 2001 level (adjusted for inflation), but actual 2004 spending is significantly higher.

The pickup in defense spending, from 3.0 percent of GDP in 2001 to 3.9 percent in 2004, largely occurred after the Sept. 11, 2001, terrorist attacks and includes military operations in Afghanistan and Iraq. As a share of GDP, defense spending remains well below the values observed during most of the past 40 years. Nondefense discretionary spending rose from 3.4 percent of GDP in 2001 to 3.9 percent in 2004; the recent values are the highest since 1985.

Tax cuts have come in three installments. A June 2001 law lowered income and estate and gift taxes; except for one minor provision later made permanent, this law is scheduled to expire in its entirety on Dec. 31, 2010. A tax stimulus package followed in March 2002. The latest tax cut, in May 2003, provided tax relief for dividends and capital gains through the end of 2008 and accelerated certain provisions of the 2001 tax cut.

In fiscal 2000, revenue reached 20.8 percent of GDP (*Chart 3*). This value was exceeded only in 1944. Without any tax cuts, economic factors would have reduced the revenue share by about 2.3 percentage points. The tax cuts reduced it by another 2.4 percentage points. The combined result is a 2004 revenue share

of about 16.1 percent, the lowest since 1959.

Official estimates of the revenue loss from the tax cuts may be overstated. These estimates assume that tax changes do not alter macroeconomic aggregates, such as GDP and employment. (The estimates do attempt to include the effects of tax changes on microeconomic variables, such as capital gains realizations and fringe benefit payments.) Under some circumstances, a tax cut can boost real GDP, causing a revenue feedback that partly offsets the direct revenue loss. Economists do not agree on the size of such a feedback, although there is a consensus that it would usually not be large enough to *fully* offset the direct revenue loss.

Economic Impact of Deficits

Government saving is the government's net investment in capital minus its budget deficit. Deficits therefore represent negative government saving, unless they finance investment in government capital. Running a deficit permits tax cuts or spending increases today. But servicing or repaying the resulting debt requires tax increases or spending cuts tomorrow.

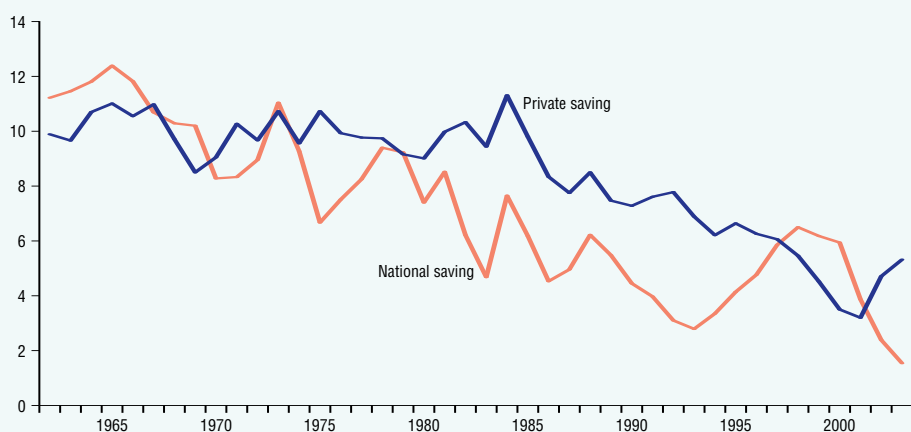
Government saving is of limited importance in its own right. It is just one component of national saving, which is the sum of government saving and private saving. (Private saving is the sum of

Running a deficit permits tax cuts or spending increases today. But servicing or repaying the resulting debt requires tax increases or spending cuts tomorrow.

Chart 4

National Saving Falls to Historic Low

Percent of GDP



SOURCE: Bureau of Economic Analysis.

personal and corporate saving). A reduction in government saving causes a reduction in national saving, unless there's an offsetting one-for-one rise in private saving.

Some policies that produce a deficit, such as tax cuts that enhance saving incentives, may cause an increase in private saving. Moreover, if households recognize that deficits will result in future tax increases or spending cuts, they may save more to prepare for those burdens. In most cases, though, it is likely that budget deficits reduce national saving to some extent.

A reduction in national saving has important economic consequences. It raises living standards today, as resources are consumed rather than saved. But it lowers living standards tomorrow, compared with what they otherwise would have been, by reducing future national income. The exact mechanism depends on whether the economy is closed or open to international trade and investment.

In a closed economy, a reduction in national saving raises interest rates and reduces investment. With less investment, the capital stock is smaller. With less capital available to aid in production, future output is lower. Lower output translates into lower incomes throughout the economy, including lower wages.

In an open economy, a reduction in national saving is likely to increase the inflow of foreign capital. This change in capital flows must be financed by a

larger trade deficit. In this case, investment need not fall—foreign savers can finance the investments for which domestic savers fail to supply funds. There is then no reduction in the capital stock or in the future output produced inside the United States. Nevertheless, the future incomes of Americans still fall, relative to what they otherwise would have been, because more of the output produced inside the United States must be paid to the foreign savers who financed the investment and own the capital.

As shown in Chart 4, private saving and national saving have generally fallen as a share of GDP throughout the past 40 years. The difference between the two series is government saving. During most of this period, national saving was lower than private saving, as government saving was negative. From 1998 through 2001, when the federal budget was in surplus, government saving was positive, so national saving was larger than private saving. In 2002 and 2003, when the federal budget moved back into deficit, government saving again turned negative.³

In 2003, private saving was 5.3 percent of GDP while government saving was negative 3.8 percent, putting national saving at 1.5 percent, the lowest value since 1934.

Although this chart shows how private saving and government saving add up to yield national saving, it does not

establish the extent to which changes in government saving have caused changes in national saving. We cannot conclusively determine what private saving would have been if government saving had been different.

Even if deficits have a significant effect on national saving, tax and spending proposals should not be evaluated solely by how they affect the deficit. The allocation of government spending across different programs is also important; for example, transfer payments do not have the same effects as spending on public infrastructure. Tax and spending changes can also affect incentives to work and save, the distribution of disposable income and the business cycle. Programs that make transfer payments from one age group to another, like Social Security and Medicare, can have profound effects on private saving and the fiscal burdens borne by different generations.

Budget Outlook During the Next Decade

Deficit Shrinks Under CBO Baseline.

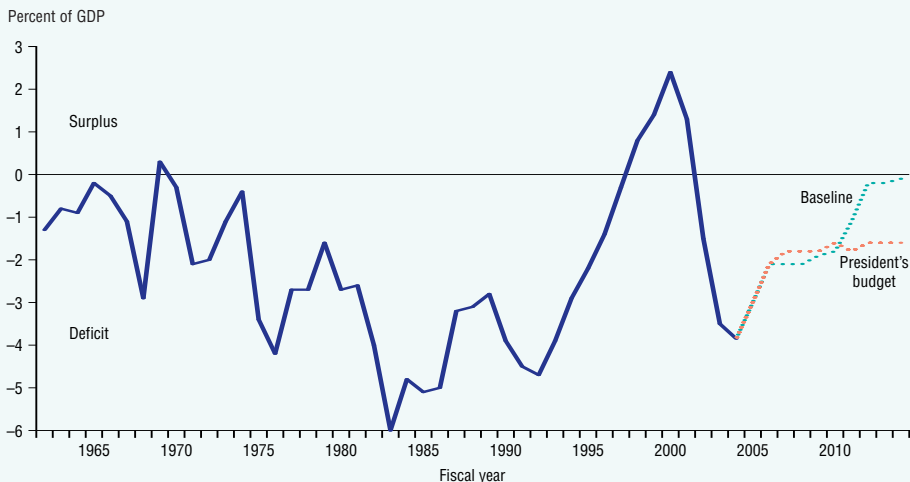
Under CBO's March 2004 baseline, the deficit shrinks, as a share of GDP, throughout the next decade, especially after 2010 (*Chart 5*). By 2014, the budget is almost in balance.

Several factors combine to produce this result. Under the baseline, discretionary spending keeps up only with inflation, meaning that it steadily declines relative to GDP. Meanwhile, revenue rises relative to GDP for three reasons:

- The brackets and exemption amounts for the regular individual income tax are adjusted each year only for inflation, not for real economic growth. As people's incomes rise faster than inflation, they move into higher brackets, a process called real bracket creep.
- The brackets and exemption amounts for the individual alternative minimum tax (AMT) are not adjusted at all, even for inflation. As a result, AMT payments will sharply increase in upcoming years—by 2010, one person in four will be on the AMT rather than the regular income tax.

Chart 5

Deficit Projected to Shrink



SOURCE: Congressional Budget Office.

A reduction in national saving raises living standards today but lowers living standards tomorrow.

- The tax cuts adopted in 2001, 2002 and 2003 become smaller after fiscal 2004 and completely expire by December 31, 2010. The expiration of the tax cuts explains the rapid shrinkage of the baseline deficit after fiscal 2010.

A countervailing factor is the growing cost of the Medicare drug benefit, which will take effect in 2006. Rising medical costs and the retirement of the first baby boomers also push up entitlement spending over the next decade. Nevertheless, the deficit still shrinks during this period under the baseline.

Deficit Shrinks Less Under President's Budget. As mentioned above, the baseline assumes that no policy changes occur. We can get a better picture of what may actually happen to the budget by examining the policy changes that Congress and the president might adopt. Consider, for example, the policy changes proposed by the president in the fiscal 2005 budget that he released in February.

While the baseline lets discretionary spending keep up with inflation, the president proposes a more restrictive policy. CBO estimates that under the president's proposals, nominal discretionary spending would grow at an average annual rate of 1.1 percent per year from 2004 to 2009, significantly less than inflation. Defense spending would grow at 1.4 percent and nondefense discre-

tionary spending at 0.7 percent. The slow growth rate for defense spending is facilitated by the fact that the costs incurred in Iraq and Afghanistan in 2004 are not expected to persist until 2009.

The president also proposes making most of the recent tax cuts permanent and adopting some other smaller tax cuts. The president's budget would therefore result in a lower revenue share than the baseline, particularly after 2010, as can be seen by referring back to Chart 3. Even so, the revenue share would still rise from the historic low reached in 2004 because of real bracket creep, the rise in AMT payments and the shrinkage of the tax cuts after 2004.

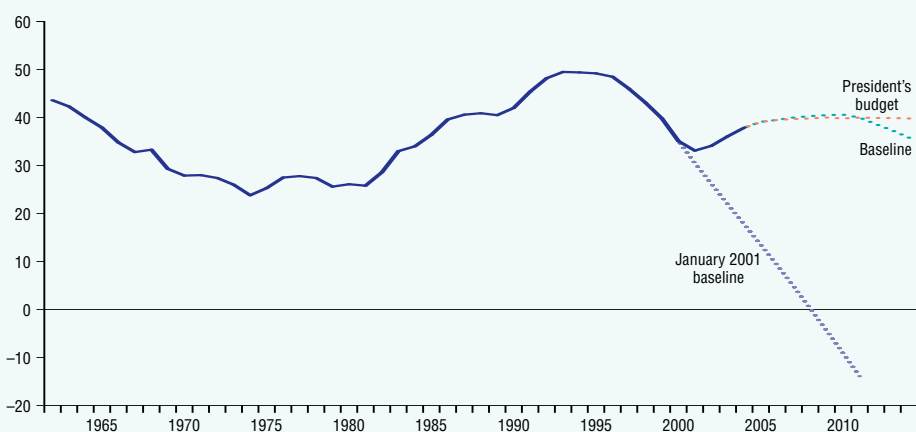
The net impact of the president's tax and spending proposals can be seen in Chart 5. The president's budget would result in slightly smaller deficits than the baseline during the next six years. After 2010, it would result in significantly larger deficits than the baseline because the tax cuts would not expire. The deficit would still shrink, though, from 3.8 or 3.9 percent of GDP today to 1.6 percent in 2014.

Debt Burden Remains Within Historical Range. Chart 6 shows the projected path of the federal debt. Under the baseline, the debt grows from 36 percent of annual GDP at the end of fiscal 2003 to 41 percent at the end of 2010. After the tax cuts expire, it declines, falling back to 36 percent at the end of 2014. Under

Chart 6

Debt Burden Projected to Remain Within Historical Range

Percent of annual GDP



SOURCE: Congressional Budget Office.

the president's budget, the debt grows from 36 to 40 percent of annual GDP over the next couple years and remains at roughly that level through 2014.

These debt burdens are within the range of recent experience—larger than those of the 1970s but smaller than those of the early 1990s. They are much larger, though, than the debt burdens projected in CBO's January 2001 baseline. Under that baseline, the entire federal debt would have been paid off by 2009.⁴

Other Factors Affecting Budget Outlook. Of course, the CBO baseline and the president's budget do not cover the full range of possible budget outcomes.

Both projections rely on CBO's economic assumptions, which, as CBO points out, are subject to great uncertainty. CBO assumes average annual real GDP growth of 2.9 percent over the next 10 years; a different growth rate would yield different budget outcomes. Interest rates, the stock market and medical costs are also uncertain.

Furthermore, the policies ultimately adopted by Congress and the president may differ from either the current policies in the baseline or those proposed in the president's budget.

Notably, neither the baseline nor the president's budget includes permanent AMT relief, even though there is a political consensus that such relief should and will be provided. The costs of such

relief grow over time and could approach 0.5 percent of GDP in 2010.

Also, there is likely to be pressure to increase discretionary spending, both defense and nondefense. Some have argued that the spending levels in the baseline, let alone those in the president's budget, are inadequate to meet public needs. In May, the president requested additional Iraq funding that had not been included in his budget.

The new Medicare drug benefit has also been criticized by some as inadequate, and there may be pressure to make it more generous. Finally, the president may propose Social Security changes that would increase deficits during the next decade, although no such proposals are in his 2005 budget.

These likely policy changes may slow or reverse the projected decline in the deficit during the next decade.

Conclusion

During the past four years, the budget has swung sharply from surplus to deficit, due to a combination of economic factors and policy changes. This development has probably reduced national saving relative to what it otherwise would have been. A reduction in national saving imposes significant economic costs—a sacrifice of Americans' future income.

Despite these costs, neither the current deficit nor those projected for the

next decade can be described as a crisis. The deficit and the debt are within their historical ranges, though toward the upper end of those ranges. Also, the deficit is projected to decline over the next decade, although that projection is subject to considerable uncertainty.

This does not mean, however, that there is no budget crisis. The short-term outlook is overshadowed by the looming Social Security–Medicare challenge, to which Federal Reserve Chairman Alan Greenspan and others have repeatedly called our attention. The projected long-run growth of these programs has profound implications for national saving, as well as for the fiscal burdens facing future generations.

—Alan D. Viard

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Notes

- ¹ CBO distinguishes between "economic" and "technical" changes. The former are revisions to the variables in CBO's economic forecast, such as GDP, employment, inflation and interest rates. The latter are changes in any other factors (except policy changes) affecting revenue or spending, such as the stock market, medical costs and income distribution. For simplicity, I combine these changes and refer to them as "economic."
- ² I classify additional interest payments resulting from the tax cuts as part of the tax cuts rather than as spending increases. Increases in refundable income tax credits paid in cash to households that do not owe income tax are classified as spending increases.
- ³ Although government saving differs from the federal budget surplus (due to such factors as government capital investment and state and local government saving), the two series usually move closely together.
- ⁴ The baseline projection recognized that it would be difficult to actually repay some of the debt before it matured. By 2009, though, the cumulative surpluses would have allowed the government to buy financial assets equal to its remaining debt, leaving it with no *net* debt.