JOINT ECONOMIC COMMITTEE

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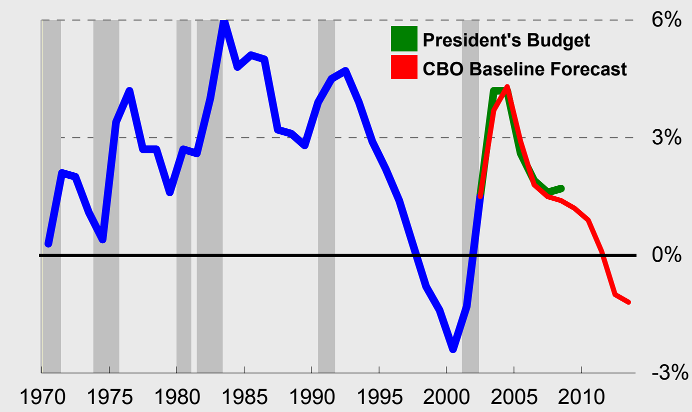
**** Updated Edition ****

UNDERSTANDING TODAY'S DEFICITS

The Congressional Budget Office (CBO) recently projected that the federal budget deficit would reach $401 billion this year and $480 billion in fiscal 2004. These projections, which are similar to recent projections released by 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.

Deficits Expand Following Recessions 1

(Federal deficits as a percentage of GDP, fiscal years)



Sources: Office of Management and Budget, Congressional Budget Office

Gray bars denote recessions

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 after the recession of the early 1990s. Following the 2001 recession, today's smaller deficits continue this pattern.

- **The weak economy and a declining tax base are the primary cause of today's deficits**. CBO reports that 52 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.

- **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.

Note: this report updates the JEC report "Understanding Today's Deficits" first issued on July 23, 2003. This updated edition uses new estimates issued by the Congressional Budget Office in August.

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, which is typically measured by the gross domestic product (GDP). As shown in Chart 1, the annual budget deficit is projected to be about 4 percent of 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

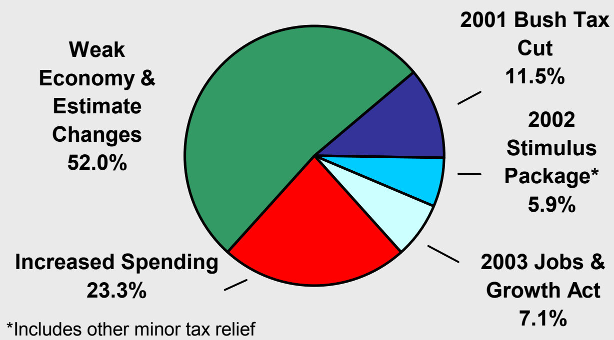
Although signs of a stronger recovery have recently emerged, the economy has been in a gradual recovery since the recession of 2001. It is common for deficits to increase, often substantially, following periods of economic weakness. As shown in Chart 1, deficits increased substantially during and after 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 CBO's FY2003 budget baseline from January 2001 to August 2003



*Includes other minor tax relief

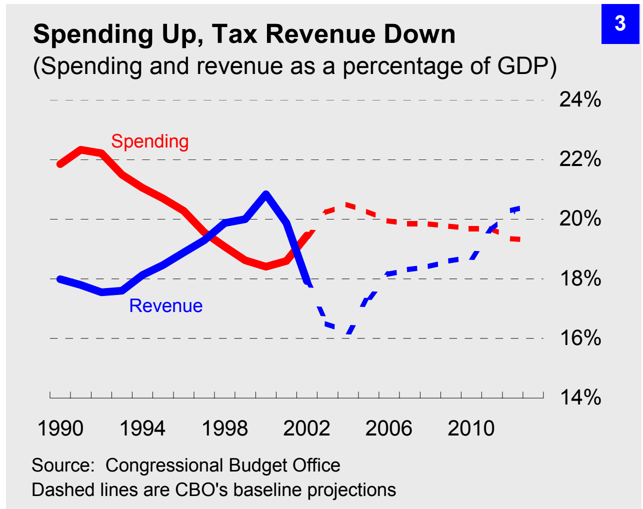
Source: Congressional Budget Office

The beginning of 2001 was the high point for projections of budget surpluses. CBO then estimated a $359 billion surplus for fiscal year 2003, while it now estimates a $401 billion deficit. As shown in Chart 2, economic changes have been the primary cause of the budget deterioration. 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 52.0 percent of the changes in CBO's projections, and none of them were due to legislation. Legislated spending increases and tax relief account for 23.3 percent and 24.5 percent of the reductions in CBO's projections, respectively (increased debt service costs have been allocated to each category). Estimates for other years by both CBO and OMB 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 estimated to be $255 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 bills had been enacted.

As illustrated in Chart 3, tax revenues are now expected to total 16.5 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.

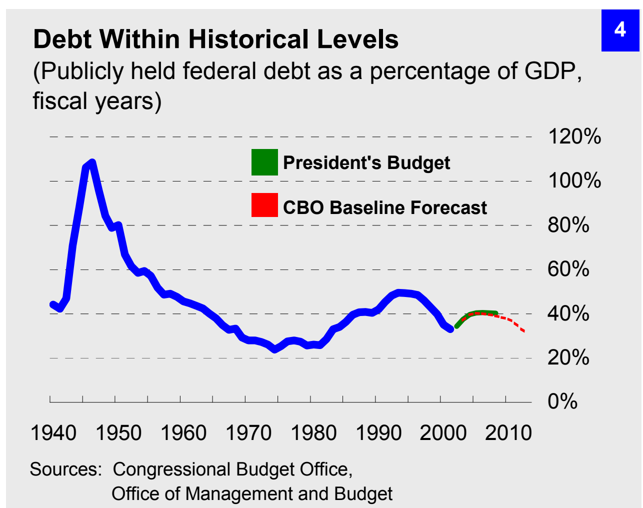


The current decline in tax revenues to 16.5 percent of GDP will likely prove to be just as ephemeral as the spike up to 20.8 percent. Lower taxes do provide a welcome boost to the U.S. economy. However, the tax system is structured so that tax revenues will grow faster than the economy. CBO projects that beginning in 2006 tax revenues will start exceeding 18 percent of GDP – their average level over the last 40 years. CBO's estimate of tax revenues in future years remains above this level even if expiring tax reductions are made permanent.

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.

The CBO baseline shows that publicly held debt will peak at 40.4 percent of GDP in 2005, after which a growing economy and declining budget deficits will reduce that ratio to previous levels (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.



Differences between CBO and OMB budget estimates

The Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) issued their mid-session reviews of the federal budget in July and August, respectively. While these two reports reveal similar trends in U.S. fiscal policy, there are a variety of differences. The most obvious of which is that CBO made budget estimates for ten years and OMB made estimates for just five years.

More importantly, the OMB report includes both a baseline estimate of current law and an estimate of the president's budget, while the CBO report focuses on a baseline (a few policy alternatives are separately estimated). Because the CBO baseline just reflects current law, it does not include proposals for making permanent expiring tax reductions, adding prescription drug coverage to Medicare, or increasing spending on other programs. However, the CBO baseline does assume the funding in this year's Iraq supplemental appropriations bill will be carried forward in future years. Finally, CBO estimates slightly faster economic growth and higher federal revenues than OMB.

Returning to budget balance requires economic growth and spending restraint

Regardless of whether CBO or OMB estimates are used for the analysis, the conclusion is the same: resumed economic growth and spending restraint are the keys to balancing the budget. 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 is now rising above 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 Budget Deficits

Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003 (http://www.cbo.gov/showdoc.cfm?index=4493&sequence=0)

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)

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

Recent JEC Publications

- **"10 Facts about Today's Economy,"** August 1, 2003. Highlights a number of positive trends that have developed throughout the last few years, despite remaining challenges in some sectors of the economy.

- **"Understanding Today's Deficits,"** July 23, 2003. Original version of JEC deficits report based on estimates from the Office of Management and Budget (OMB).

The above JEC publications and other information are on-line at http://jec.senate.gov/.