Interpreting the Return to Budget Deficits

John S. Irons*
July 2003

Policy Summary

The White House Office of Management and Budget (OMB) recently projected that the US federal budget will see an unprecedented $691 billion deterioration in its budget situation – moving from record surpluses of $236 billion in 2000 to record deficits of $455 billion in 2003. This paper outlines some of the basic characteristics of the current situation and places them in the context of recent history.

The current $455 billion deficit is:

- the highest deficit in current dollar terms in history
- the highest deficit adjusted for inflation since WWII
- $1,561 per person
- 4.2% of GDP

In addition, when you exclude the social security surplus, the deficit is currently 5.7% of GDP and the second largest percentage since WWII (only the 1983 budget under Reagan had a larger deficit.)

Scope of the Deficit

The figures below show the pattern of the deficit over the last 40 years. As you can see, the last three years have seen an unprecedented slide in the fiscal situation.

Figure 1 shows the inflation-adjusted value of the deficit, and Figure 2 shows the deficit as a percentage of GDP. Without the Social Security trust fund, the situation is even worse – in 2003, the deficit is estimated to be $614 billion, or 5.7% of GDP. Figure 3 shows the deficit excluding the surplus from the social security trust fund as a percent of GDP. Since WWII, only in 1983 was this deficit greater.

* The author is a Senior Economic Research and Policy Analyst, and can be reached at jsirons@ombwatch.org.

Figure 1.
Budget Surplus/Deficit
(Inflation adjusted, billions of 2002 dollars)

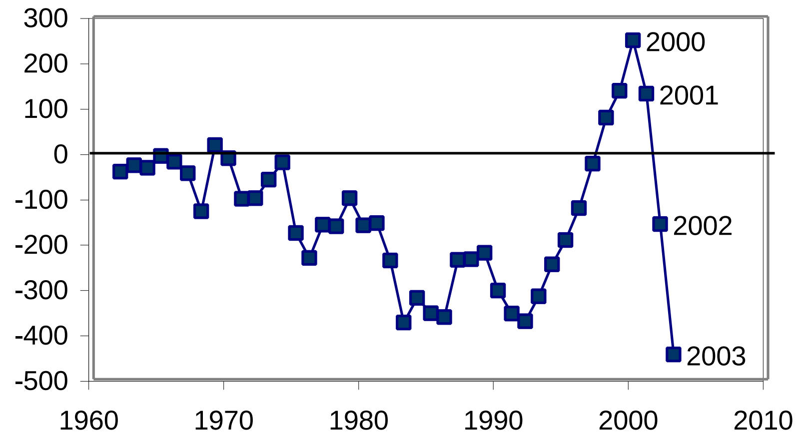
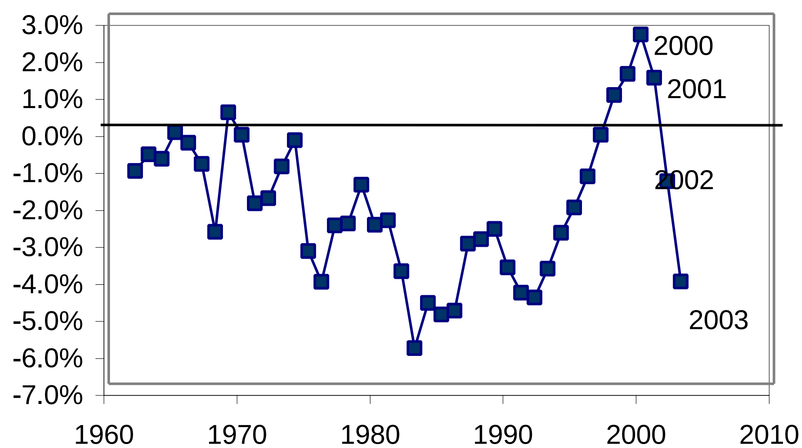
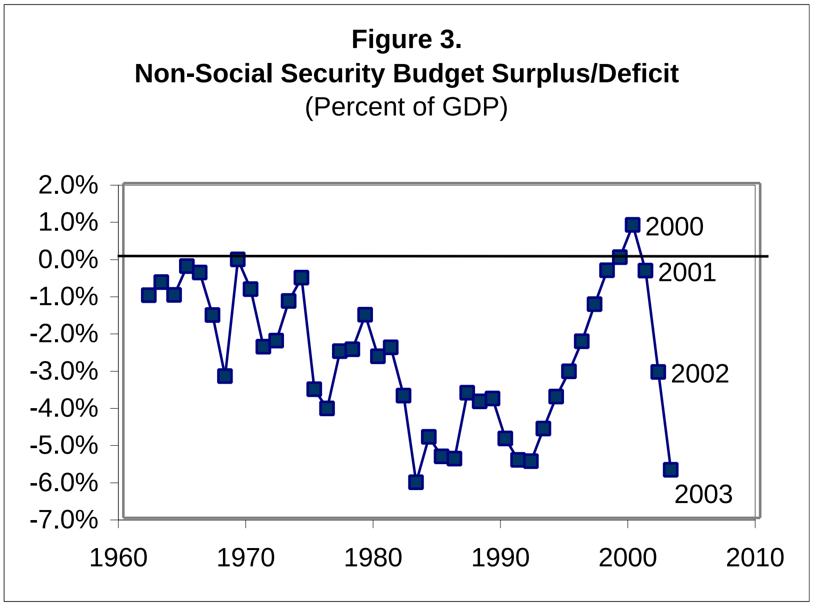


Figure 2.
Budget Surplus/Deficit
(Percent of GDP)

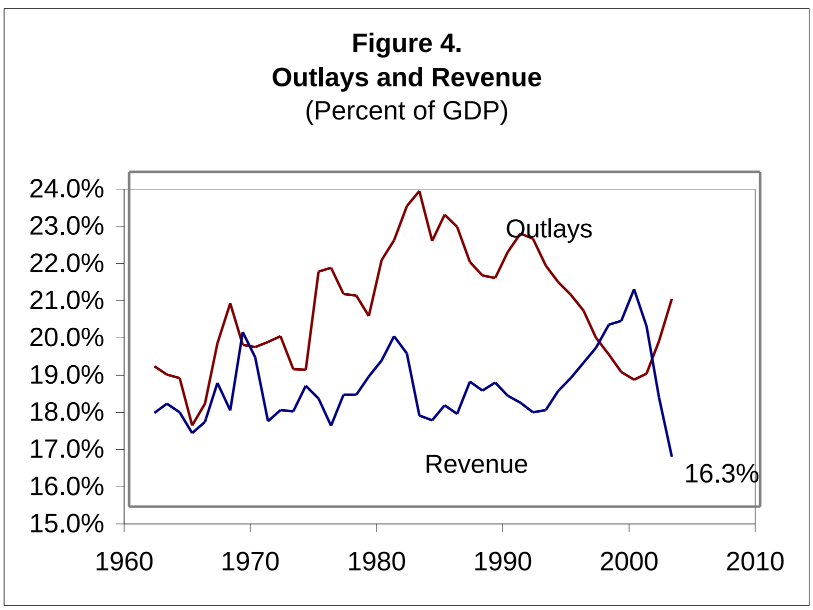




Cause of the Deficit

There are several reasons for the dramatic deterioration of the budget situation. The primary cause has been the dramatic decline in revenues, which have dropped to 16.3% of GDP – the lowest level since 1959. To a lesser extent increased expenditures, especially on military activities, have played a role as well.

Part of this can be explained by a weak economy, and part by the tax cuts enacted over the past three years. However, the recession that began in March 2001 was, by historical standards, relatively mild. In addition, recent recessions have not seen revenue declines of nearly the same magnitude as the current recession (see Figure 4.) This suggests that a large part of the revenue reduction was due to enacted tax legislation.



OMB's midterm review[1] claims that 53% of the overall deterioration from the April 2001 budget projections for 2003 was due to the economic downturn, while only 23% (or $177 billion) was due to the tax reductions of the past three years. These figures are, however, misleading. These percentages were calculated using the size of the budget deterioration from an earlier *projection* of the 2003 surplus, not the change from the *actual* 2000 surplus. To the extent that the economic projections were overly optimistic in 2001 (as they turned out to be), the share of the deterioration due to economic factors is overstated. See below for errors in OMB's economic projection.

Structural deficit

In addition to budget estimates, the congressional budget office also calculates a "standardized" budget, which is the deficit that would have been in place if the economy were operating at its potential level.[2] In 2002, the CBO estimated that of the $158 billion deficit for that year, $153 billion was the standardized deficit. This was down from a standardized surplus of 99 billion in 2000; thus indicating a $254 billion dollar deterioration of the budget situation purely as a result of enacted policies and net of economic conditions. In addition, this number does not include the 2003 revenue reduction legislation.

Future Deficits

Economic projections by OMB have recently been overly optimistic (see Table 1). In April 2001, even though the administration saw weakness in the economy in the first part of the year,[3] GDP growth was projected to be relatively solid, and unemployment was seen to be low. More recent projections have been more accurate, but they have each predicted a strong recovery just around the corner, yet no strong recovery has come.

Table 1. GDP and Unemployment, 2000-2003[4] as forecast in April 2001, February 2002, and February 2003

	GDP Forecast				Unemployment Forecast			
	2001	2002	2003	Actual	2001	2002	2003	Actual
2000	-			2.8	-			4.0
2001	2.6	-		0.1	4.4	-		4.8
2002	3.3	2.7	-	2.9	4.6	5.9	-	5.8
2003	3.2	3.8	3.4	1.4*	4.5	5.5	5.6	6.0*

* Note: 2003 "actual" figures for the first part of the year: GDP(QI) and January through June unemployment.

[1] See http://www.whitehouse.gov/omb/budget/fy2004/msr.html.
[2] This is sometimes called a "structural" deficit. The potential level of GDP is calculated by assuming that the economy is operating at the nonaccelerating inflation rate of unemployment (NAIRU). For 2002, this unemployment rate was assumed by the CBO to be 5.2%. See http://www.cbo.gov/showdoc.cfm?index=1821&sequence=0#table1.
[3] See http://w3.access.gpo.gov/usbudget/fy2002/pdf/spec.pdf, Section 1.
[4] Source: annual budgets, http://w3.access.gpo.gov/usbudget/, and April 2001 budget.

Economic forecasting is an imprecise and difficult science, and in early 2001 the extent of the economic downturn throughout 2001 were not yet known; however, the continuing increases in budget deficit forecasts are not encouraging.

Table 2 shows that the forecasts for the 2003 budget deficit have continued to increase since early 2001. Part of these increases is due to the economic situation and part is due to legislation. The administration is left with a choice – either their economic assumptions have repeatedly been overly optimistic, or changes in tax law have created a massive hole in the budget.

Table 2. Estimates of surplus/deficits for 2003[5]

Date of estimate	2003 surplus ($)
April 2001	+242 billion
February 2002	-80 billion
February 2003	-304 billion
July 2003	-455 billion

Even the latest $455 billion estimate assumes an immediate recovery with higher GDP growth and lower unemployment. If the experience of the past two years is repeated, we can count on much greater deficits than projected by OMB.

In addition, it is likely that the administration will ask for more money for military activities in Iraq. Plus, if the fire season in the west gets worse, or if this year yields a bad hurricane season, or if there were any other unexpected expenses, it would be nice to have a little breathing room; however, the current budget has already more than used up any buffer it once had.

Finally, lawmakers are likely to want to extend tax cut provisions currently scheduled to expire in the next few years. Additional legislation to reform the alternative minimum tax is also likely in the not-to distant future. These and other legislative actions bring into question the value of the published 5-year budget projections.

Are deficits bad?

Persistently large deficits can be bad for the economy since they can lead to higher long-term interest rates and can depress national savings. In addition, large debt amounts can lead the economy down an unsustainable path. Each of these effects could harm the economy. Furthermore, deficits simply push off the burden to future generations. This is particularly troubling with the coming retirement of the baby boomer generation.

However, deficits do allow the government to finance vital national priorities, and can buffer the effects of economic fluctuations. The current level of deficits will hopefully prove to be, in OMB director Bolten's words, "manageable." However, the persistence and the magnitude of the deficits, especially considering current and future needs that are going unmet, as well as the unprecedented dive from surplus to deficits, are a sign that the current administration is not acting in a responsible manner on tax and budget issues.

[5] Source: annual budgets, http://w3.access.gpo.gov/usbudget/.