

Aye, Aye, Captain: Deficits as Far as the Eye Can See

As the presidential campaign heats up, the economy will occupy one of the front burners on the political stove. Some discussions will fold the government budget deficit ingredient into the economic stew. Answers to several questions about government deficits will prove useful background for the debates ahead. To wit, how should we measure the deficit? What factors contributed to the recent movement from a surplus to a deficit? How does the current deficit compare to deficits of the past? Should the deficit be a major concern for policy makers in the future?

How Best to Measure the Deficit:

The federal government budget deficit measures how much revenues fall short of spending. If the government spends more than its income, then it must go into debt and borrow the difference to finance any spending beyond its income. Comparing government deficits over time is tricky because of inflation and output growth. To address these problems, standard practice expresses the government deficit as a fraction of nominal gross domestic product (GDP), since nominal GDP grows with inflation and output growth. For example, doubling the deficit does not reflect a change in fiscal stimulus, if nominal GDP also doubles. That is, the deficit as a fraction of nominal GDP does not change.

The federal budget deficit adjusts in response to business cycle movements and to changes in tax and spending policy. President Reagan's first term provides a good example of the latter. During the campaign, he pledged to cut taxes, increase defense spending, and lower social service spending. In the final analysis, he got the tax cuts and the increase in military spending, but not the hoped-for cuts in social service spending. Thus, the federal budget deficit rose during his first term of office, since expenditure to GDP rose and revenue to GDP fell.

Concerning business-cycle effects, incomes rise and unemployment falls when the economy expands, causing tax revenue to increase and government spending on transfers such as unemployment compensation to decrease. That is, the government deficit falls during expansions and rises during recessions, even though the government does not explicitly change any tax or spending policies. Economists refer to such movements as

the automatic stabilization built into the fiscal system. That is, when the economy grows, the budget deficit automatically falls, tending to retard and, thus, stabilize that growth.

For example, President Clinton's administration combined the effects of an expanding economy and a changing structure of taxes and spending plans to reduce the deficit. Every year of his administration, expenditure to GDP fell, revenue to GDP rose, and the deficit to GDP fell, becoming a surplus in the latter years of his two terms.

Recent Budget Deficit Adjustments

When President Bush came into office, the federal government had just run a surplus of 1.9 percent of GDP in 2000. In other words, the federal deficit to GDP equaled minus 1.9 percent. Revenue to GDP stood at 20.9 percent of GDP, the highest level it had ever posted. Spending to GDP stood at 19.0 percent of GDP, its lowest level since 1973. By the end of 2003, the federal deficit rose from -1.9 to 3.8 percent of GDP, a 5.7 percent change in three years. This sharp rise in the federal deficit nearly reversed the significant decline in the deficit over the Clinton administration, where it fell from 4.7 to -1.9 percent of GDP over eight years, a 6.6 percent decline.

Examining the component parts of the federal deficit illustrates the following additional facts. Revenue to GDP fell from 20.9 to 16.8 percent of GDP, a decline of 4.1 percent. Spending to GDP rose from 19.0 to 20.6 percent of GDP, an increase of 1.6 percent. In other words, over two-thirds of the increase in the federal deficit share of GDP reflected revenue declines.

What can we make of these numbers? First, why did the deficit rise? Three factors played a role – the economic recession, the three legislated tax cuts, and the increases in government spending. Second, how important a role does each explanation play in the overall picture? Alan Viard at the Dallas Federal Reserve Bank projects that 40 percent of the increase in the federal deficit reflected deteriorating economic conditions. The remaining 60 percent reflected policy changes, which about evenly divide between tax cuts (33 percent) and spending increases (27 percent). The spending increases primarily affected discretionary items. Since economic activity mostly affects revenue and not spending, this breakdown corresponds roughly to my observation above that revenue reductions explain just over two-thirds of the increase in the deficit.

Does the Budget Current Deficit Represent a Major Problem?

The federal deficit in 2003 fell in the upper range of past deficits to GDP. Ignoring the war years of 1942 to 1945, the deficit to GDP ratio exceeded the 2003 value of 3.8 percent in 1975, 1982-1986, and 1992-1993, where the largest value was 4.9 percent in 1983. Thus, the federal deficit, although recording its largest value in dollar terms in 2003, does not appear out of line with past deficits relative to GDP.

The component of the deficit most out of line with past practice is revenue. The 2003 revenue share of GDP reached its lowest level since 1965. The 2003 spending share of GDP, on the other hand, recorded a lower value that it achieved in each year from 1980 to 1996.

What about the Future?

The Congressional Budget Office (CBO) projects in their baseline forecast that the deficit should return to balance by 2010. The CBO baseline forecast, however, assumes no policy changes. That is, the government will not change, for example, those tax cuts due to expire in 2010. Most pundits anticipate that those tax cuts will not expire, which prevents the balancing of the deficit by 2010, absent other adjustments (e.g., slowed spending growth). The CBO forecasts that the President's budget, which does propose making his earlier tax cuts permanent, will see the deficit hover around 2 percent of GDP through 2010 and beyond.

In sum, whether budget deficits will stretch into the future as far as the eye can see depends on the assumptions involved in the forecast. Based on President Bush's current budget proposal, the statement probably is accurate.

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Edited version appeared in *In Business*, August 6-August 12, 2004.