The Economy Today

NEWS FLASH

Newsletter for Teachers of Economics to accompany Bradley R. Schiller's *The Economy Today* and *Essentials of Economics* texts.

Dangerous Deficits?

On October 16, Treasury Secretary Tim Geitner and Office of Management and Budget (OMB) director Peter Orzag announced the federal budget results for Fiscal Year 2009, which ended on September 30. In FY 2009, the federal government spent $3.522 trillion but took in only $2.105 trillion of revenue. That left the government deeply in the red, with a budget deficit of $1.417 trillion.

The FY 2009 deficit was a modern record-breaker. Past deficits have never been more than $500 billion a year and were rarely over $200 billion. Last year's budget, by contrast, pushed deficit measures well into trillion-dollar metrics. Even when gauged in relative terms, last year's deficit leaves all its predecessors in the dust. In the last 60 years, the budget deficit exceeded 5 percent of GDP in only two years (1983, 1985). It exceeded 4 percent of GDP in only seven years. In 2009, however, the deficit jumped to 10.5 percent of GDP–the highest deficit ratio since World War II (when consumer goods were rationed and people invested their savings in War Bonds).

How did the government's deficit mushroom so quickly? Two distinct forces have been in play. The first, of course, was the Great Recession of 2008-2009. Recessions throw people out of work, shrink paychecks, and depress other forms of income. This reduces taxable incomes and ultimately the government's tax revenues–revenues fell by $419 billion last year.

Recessions also cause more people to apply for unemployment benefits, welfare assistance, and Social Security checks. As a result, the government is compelled by prior legislation to increase its spending on income transfers. The combination of reduced tax revenues and increased income-transfer spending enlarges the budget deficit.

Discretionary fiscal policy also weighs in here. The Keynesian mandate for ending a recession calls for fiscal stimulus–i.e., spending hikes and tax cuts that will shift aggregate demand into high gear. Washington heeded this mandate in 2008-09. The fiscal stimulus started in February 2008 with $168 billion of income tax rebates and a jump in federal spending. Then President Obama pushed a $787 billion stimulus package of tax cuts and new spending thru Congress in February of this year. These policy initiatives added more fuel to the deficit fires. Federal spending increased by $544 billion last year.

Cyclical vs. Structural Deficits

To distinguish the relative size of recessionary and discretionary impacts on the budget deficit, we separate the total deficit into two components:

Total Deficit = $\boxed{\text{Cyclical Deficit}}$ + $\boxed{\text{Structural Deficit}}$

Cyclical Deficit: If the economy were at full employment, there would be no recession and therefore no deficit due to recessionary forces. When the economy is operating below its full-employment capacity, however, those automatic stabilizers kick in to increase government outlays and reduce tax revenues. The "cyclical deficit" gauges the resulting budget impact.

Structural Deficit: The structural deficit measures the imbalance between legislated tax and spending levels at full employment. At full employment, there would be no cyclical deficit. Therefore, any remaining deficit at full employment must be attributed to discretionary policy decisions about how much to spend and tax.

CBO Breakdown of 2009 Deficit

The Congressional Budget Office (CBO) estimates that the 2009 deficit broke down as follows:

Cyclical Deficit	$ 260 billion
Structural Deficit	$1,157 billion
Total Deficit	$1,417 billion

By their calculation, **the 2009 deficit was overwhelmingly due to discretionary policy, not the recession**. In FY 2009 this discretionary spending consisted of bank bailouts (the Troubled Assets Relief Program (TARP) and stimulus outlays from the American Recovery and Reinvestment Act.

Projecting Future Deficits

The massive deficit of 2009 has raised concerns about where future deficits are headed. Will we ever rein in soaring deficits? To project the path of future deficits, one has to forecast not only the economic outlook but policy developments as well. When the CBO last peered into its crystal ball (August 2009), it foresaw unemployment continuing to rise through the rest of this year, peaking at 10.2 percent next year. This continued slack in the economy will keep the cyclical deficit growing. CBO now projects the cyclical deficit will peak at $406 billion in FY 2010, then start receding slowly.

The Obama stimulus package (the American Recovery and Reinvestment Act of 2009) has only been partially implemented. Close to $400 billion is still to be spent on infrastructure and energy independence over the next couple of years. The modest tax cuts in the Obama package also extend to future years. So the structural deficit isn't going to disappear anytime soon either. As CBO sees it, the deficits for the next couple of years will be (in $ billions):

Year	Cyclical Deficit	Structural Deficit	Total Budget Deficit
2009	-260	-1,157	-1,417
2010	-406	-975	-1,381
2011	-387	-534	-921

In both absolute and relative turns these deficits would continue to be the highest peace time deficits in American history.

Pure Optimism?

The CBO's projections could prove to be overly optimistic. When the CBO peers into its crystal ball, it only gazes at the future path of the economy, not future legislation. In its "baseline" projections it only takes into account tax and spending laws that Congress has already enacted. By statute, the CBO does not predict or even handicap future Congressional action. This means that its projections of the structural deficit exist in a policy void. They will prove accurate only if Congress takes a multi-year recess (which would gladden the hearts of many ultra-conservatives!). After the fact, CBO explains its erroneous projections by its own misreading of the economic tea leaves and "unanticipated" legislative developments.

This time around, we've got a pretty good idea of what some of those "unanticipated" legislative developments might be. The elephant in the room is health care reform. President Obama clings to this legislative priority. The CBO has said President Obama's preferred plan could add nearly a trillion dollars to the budget over the next decade. Extensions of income-transfers eligibilities would tack on additional budget pressures and there is increasing talk in Washington, D.C. about the need for a second stimulus program that will bring the unemployment down before next year's midterm elections. While no one knows for sure what laws Congress will pass in the next couple of years, President Obama's

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agenda, a democrat-controlled Congress and pre-election jitters pretty much guarantee that the structural deficit will turn out to be larger than CBO's "baseline" projection.

How Much Harm?

How scary is the prospect of continuing deficits in the trillion-dollar range? Although politicians like to warn about passing the costs of soaring deficits to our grandchildren, the real burden of deficits occurs much sooner. The most tangible burden is the crowding out threat. If and when the economy again approaches full employment, government spending on infrastructure, alternative energy, and health care will inevitably compete with private spending for both real resources and funds. This competition will intensify wage, inflation, and interest-rate pressures. Something will have to give. Either higher taxes or interest rates (or both) will "crowd-out" some consumption or investment.

The burden of soaring deficits will also include a weaker dollar. Foreign governments and institutions now hold nearly a third of America's $12 trillion national debt. Like any creditor, they want to know their loans are secure. As Uncle Sam continues to borrow massive amounts of money, bond holders–especially foreign owners–get jittery. This makes them less willing to hold dollar-denominated assets, including U.S. bonds, stocks, and real assets. The resulting dollar weakness makes imports and foreign investment more expensive for Americans. That creates another form of crowding out for the American consumer.

The Obama administration recognizes the dangers that soaring deficits pose. OMB director Orzag tried to assure people that "the President recognizes that we need to put the nation back on a fiscally sustainable path." President Obama himself has said he's scrutinizing the budget "line by line," looking for potential spending cuts. But with both the White House and the Congress pushing more spending (e.g., $250 payments to seniors, added stimulus projects, expanded health care), and the pending surge in Baby-Boomer retirements, deficit dangers are likely to rise, not diminish.

WEBNOTES: The October 16 White House statement on the FY 2009 deficit is at www.treasury.gov/press/releases/tg322.htm. Data on the size and ownership of U.S. debt is available at fms.treas.gov/bulletin/index.

TEXT NOTE: More discussion of debt and deficit burdens is in Chapter 12 of the recently published 12th edition of *The Economy Today.*

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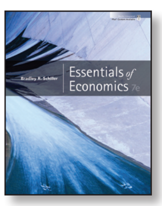

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