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The Federal Fiscal Outlook

This Public Policy Brief presents recent forecasts of the U.S. federal government deficits and publicly held federal debt, along with brief commentary by economic research staff at the Federal Reserve Bank of Boston. It is based on materials presented in an internal policy briefing on April 29, 2004. Contributors to this brief include Radoslav Raykov and Robert Triest. Views expressed in this brief do not necessarily reflect the views of the Federal Reserve System.

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Future Federal Budget Deficits Depend on Policy Choices

Chart 1 shows the Congressional Budget Office's (CBO) baseline federal budget deficit projections for fiscal years 2003-2014, along with three sets of deficit forecasts from Global Insight (formerly DRI). The CBO baseline assumes that current tax law is not changed (and so the Bush administration's tax cuts disappear as currently mandated) and that real discretionary spending is constant. The three Global Insight forecasts differ in the macroeconomic assumptions on which they are based.

The current federal budget deficit will likely be between 4% and 4.5% of GDP in fiscal 2004. Although this is large, a sizable deficit was desirable for stabilization purposes while the strength of the recovery was uncertain. Under current tax law, and with discretionary spending held constant in real terms (CBO's "baseline" scenario), the federal deficit would likely shrink to about 2% of GDP over the next 3 years as the recovery continues. The budget would be nearly balanced starting in 2012 due to the reversal of the recent tax cuts (as specified under current law).

What will actually happen to the deficit depends on policy choices and macroeconomic conditions. Chart 2 shows the effect of alternative policy assumptions on the deficit forecasts. All of the forecasts are from CBO, except for the Office of Management and Budget's (OMB) forecast of the President's budget proposal (which is very similar to CBO's estimates of the deficits which would result from the President's proposal). In addition to the baseline and the President's budget proposal, three alternative scenarios analyzed by CBO are shown this chart. CBO alternative case 1 forecasts deficits under the assumption that all of the Bush era tax cuts are made permanent (including the bonus depreciation provision). CBO alternative case 2 assumes that in addition to the tax cuts being made permanent, the tax brackets of the AMT are indexed for inflation. CBO alternative case 3 assumes that discretionary spending grows at the same rate as GDP (rather than being constant in real terms) in addition to the tax cuts being permanent and the Alternative Minimum Tax (AMT) being indexed.

Under the President's budget proposal, which makes the tax cuts permanent, the deficit would decrease to 2.1% of GDP by fiscal 2006, and then stabilize at roughly 1.6% of GDP in 2012. An arguably more realistic scenario, which includes reform of the AMT and somewhat greater discretionary spending, would result in the deficit exceeding 4% of GDP in 2012.

The Current Situation in Historical Perspective

In evaluating the current federal fiscal situation, it is helpful to look at today's fiscal outlook in the context of recent history. Chart 3 shows historical data on federal outlays and receipts. The current fiscal imbalance is due primarily to a very sharp drop in tax revenue (as a share of GDP); increased spending has played a smaller role. Chart 4 puts the deficit projections in historical context. The current deficit is large (as a percentage of GDP), but considerably smaller than the peak deficit years of the early-to-mid 1980s.

The effect of government deficits and debt on interest rates is a very controversial subject in economic research. Although in some models sustained deficits have no effect on interest rates, in others sustained deficits and an increase in the ratio of government debt to GDP increases interest rates. Two recent research papers estimate that a one percentage point increase in the ratio causes the yield on 10-year Treasury notes to increase 3 to 5 basis points.[1]

Chart 5 shows past and projected values of publicly held Treasury debt as a percentage of GDP. Under current law (and constant real discretionary spending), that

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[1] The two studies are: Engen, Eric and R. Glenn Hubbard, "Federal Government Debt and Interest Rates," presented at the NBER Macroeconomics Annual conference, April 2004, and Thomas Laubach "New Evidence on the Interest Rate Effects of Budget Deficits and Debt," Finance and Economics Discussion Paper 2003-12, Federal Reserve Board of Governors.

ratio would increase up to fiscal year 2007 and then remain roughly constant before starting to fall in 2011 (with the budget nearly balanced, output growth results in a falling ratio). Under the President's budget proposal, the ratio would stabilize starting in 2007 (the continued deficits would offset the effect of output growth, leaving the ratio roughly constant). The ratio would continuously increase under the scenario allowing for reform of the AMT and increases in discretionary spending.

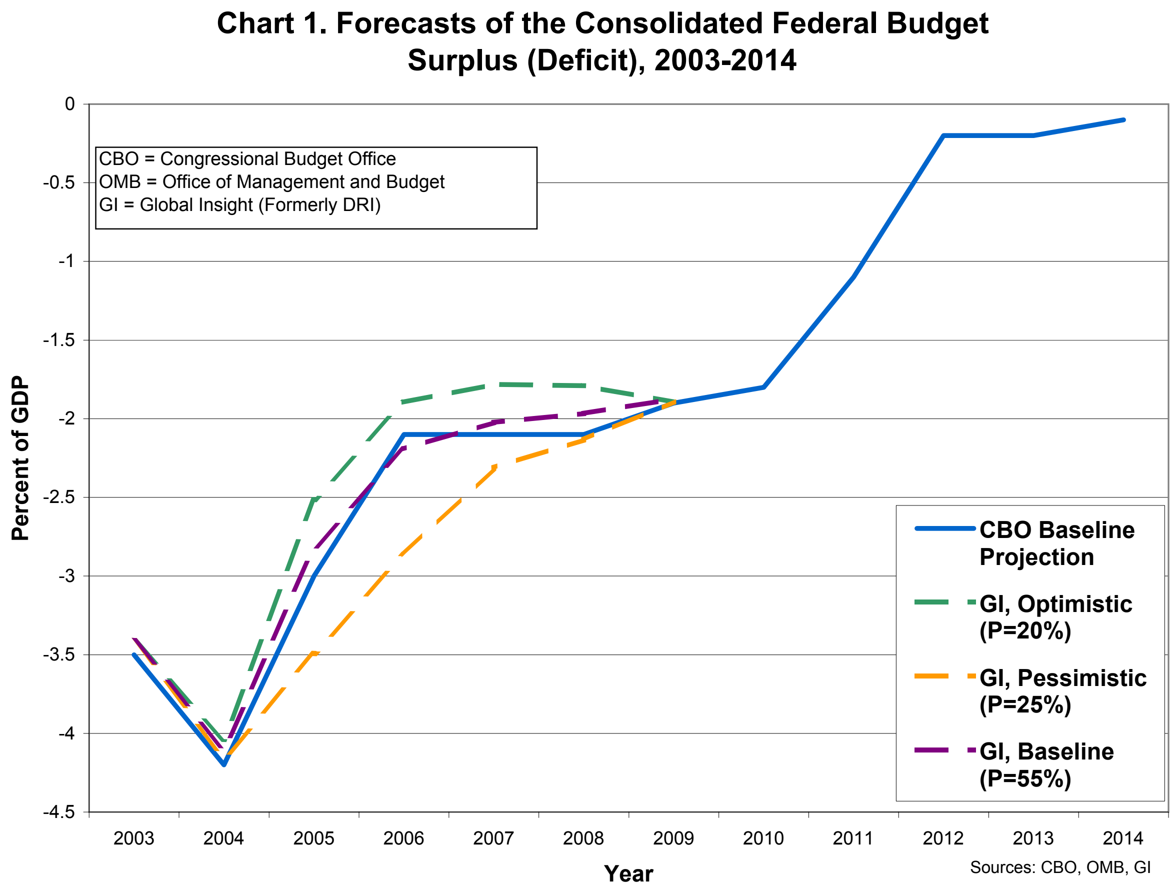


Chart 1. Forecasts of the Consolidated Federal Budget Surplus (Deficit), 2003-2014
CBO = Congressional Budget Office
OMB = Office of Management and Budget
GI = Global Insight (Formerly DRI)
CBO Baseline Projection
GI, Optimistic (P=20%)
GI, Pessimistic (P=25%)
GI, Baseline (P=55%)
Percent of GDP
0
-0.5
-1
-1.5
-2
-2.5
-3
-3.5
-4
-4.5
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Year
Sources: CBO, OMB, GI

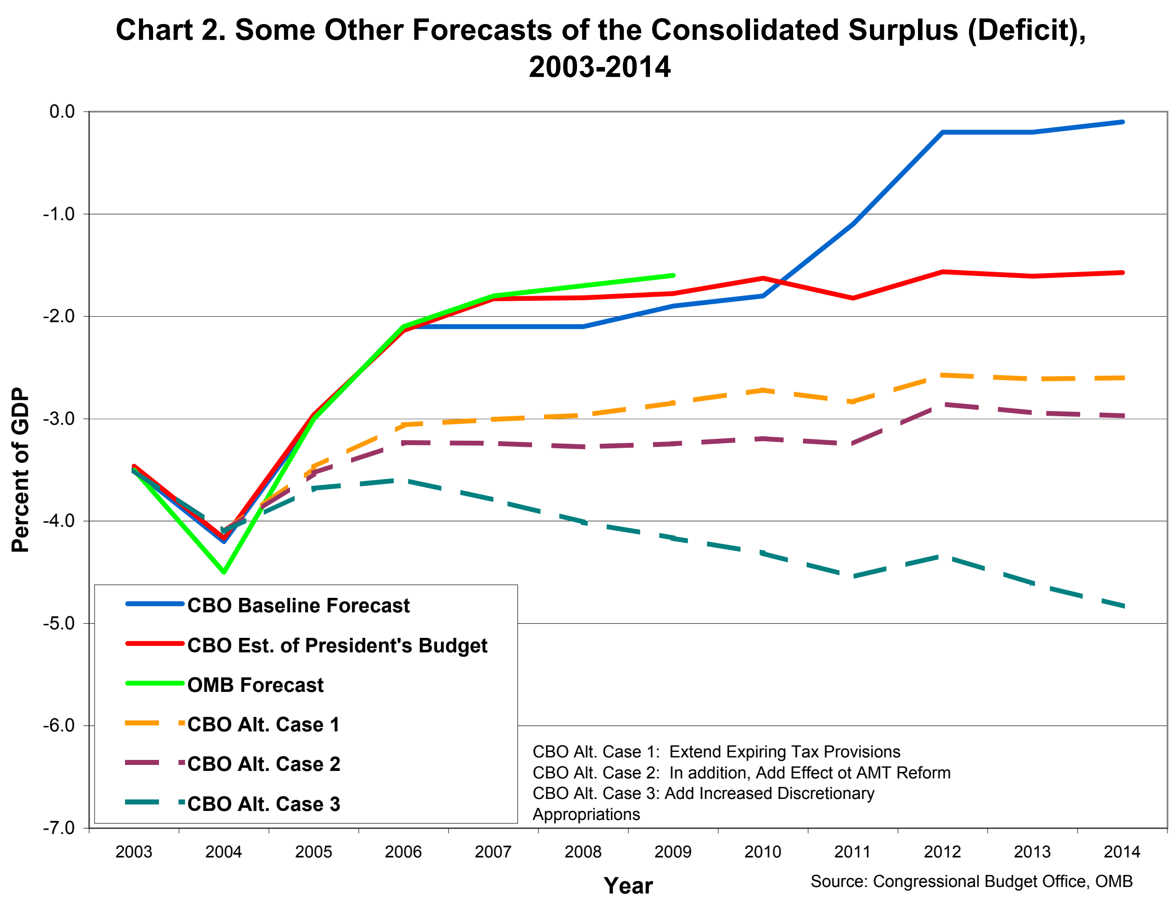


Chart 2. Some Other Forecasts of the Consolidated Surplus (Deficit), 2003-2014
CBO Baseline Forecast
CBO Est. of President's Budget
OMB Forecast
CBO Alt. Case 1
CBO Alt. Case 2
CBO Alt. Case 3
CBO Alt. Case 1: Extend Expiring Tax Provisions
CBO Alt. Case 2: In addition, Add Effect ot AMT Reform
CBO Alt. Case 3: Add Increased Discretionary Appropriations
Percent of GDP
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
-6.0
-7.0
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Year
Source: Congressional Budget Office, OMB

Chart 3. Federal Receipts and Outlays as Percent of GDP, 1960-2014

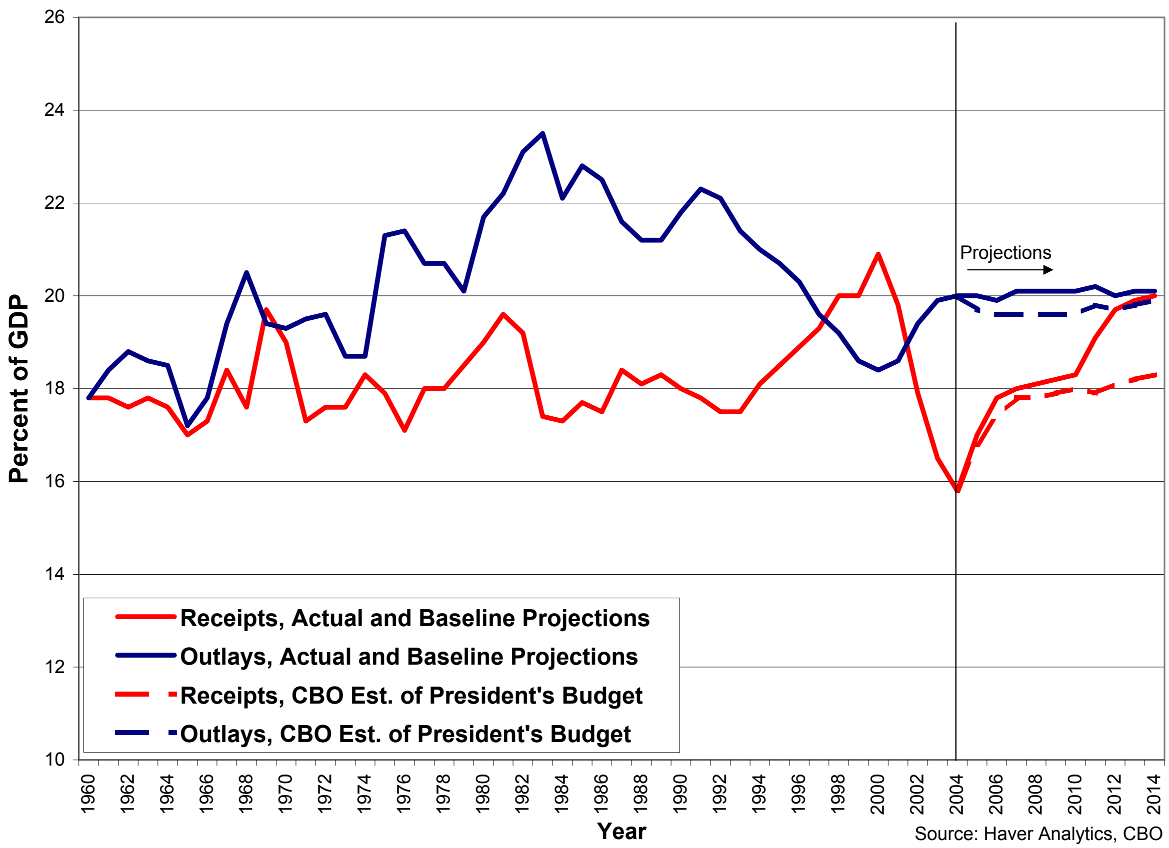
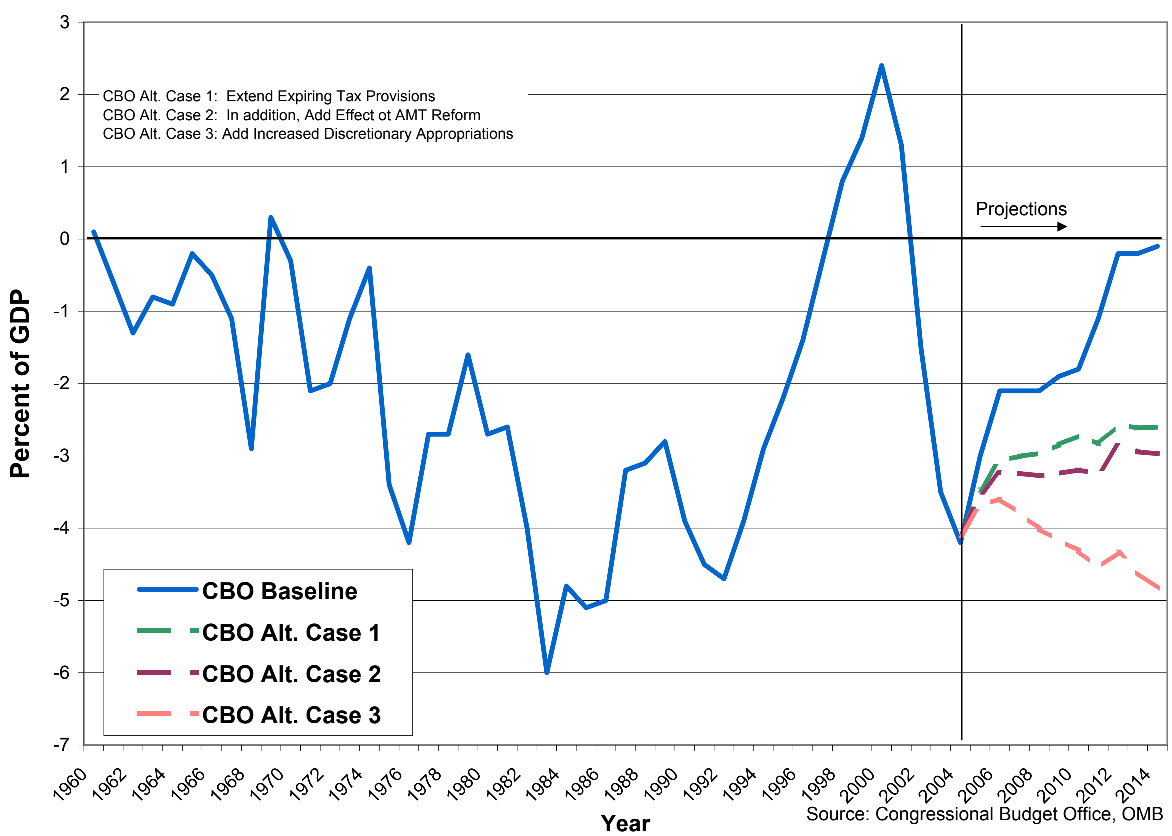


Chart 4. Actual and Projected Budget Surplus (Deficit), Three Different Scenarios from the CBO for 2003-2014



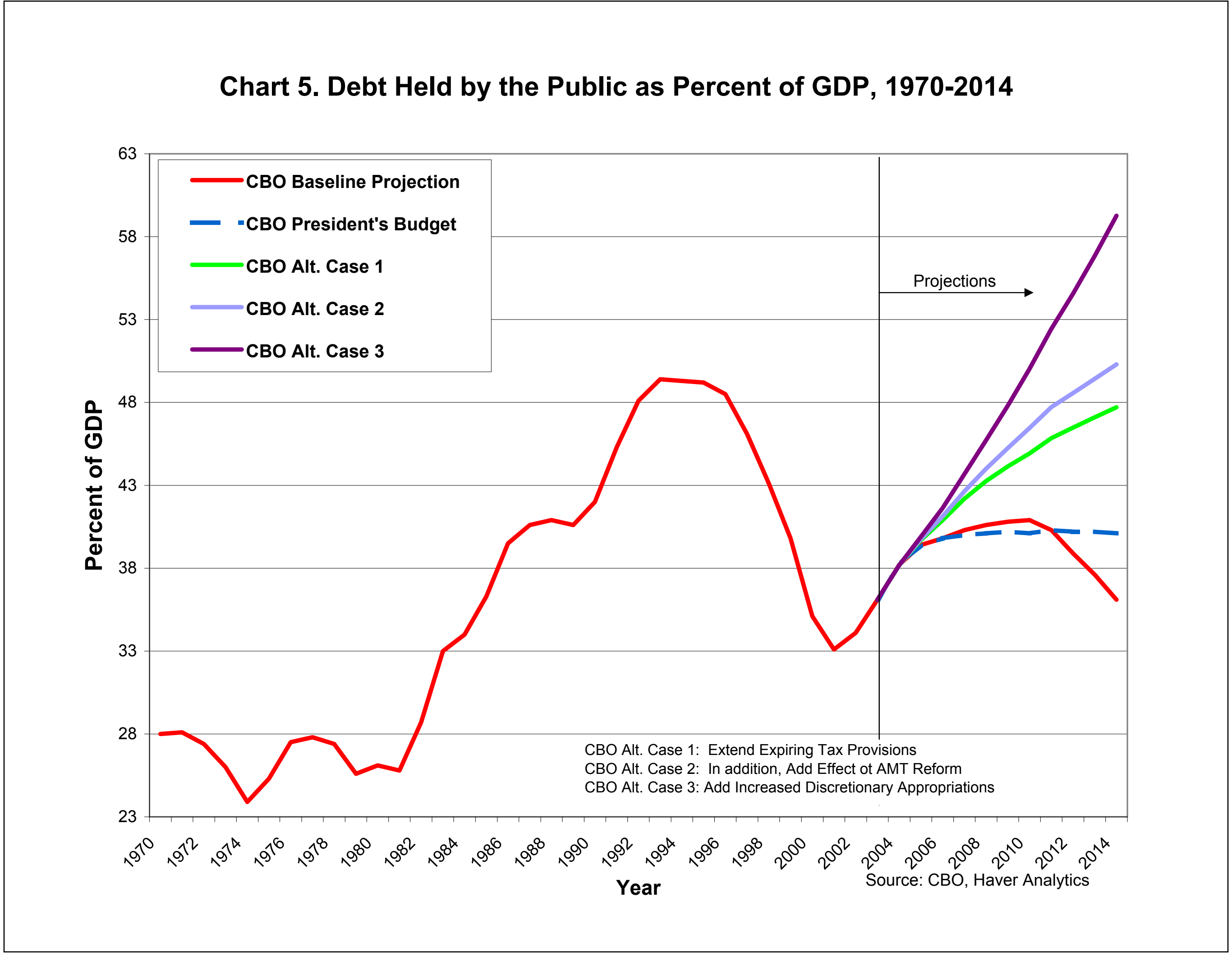


Chart 5. Debt Held by the Public as Percent of GDP, 1970-2014
CBO Baseline Projection
CBO President's Budget
CBO Alt. Case 1
CBO Alt. Case 2
CBO Alt. Case 3
Projections
Percent of GDP
63
58
53
48
43
38
33
28
23
CBO Alt. Case 1: Extend Expiring Tax Provisions
CBO Alt. Case 2: In addition, Add Effect ot AMT Reform
CBO Alt. Case 3: Add Increased Discretionary Appropriations
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
Year
Source: CBO, Haver Analytics