IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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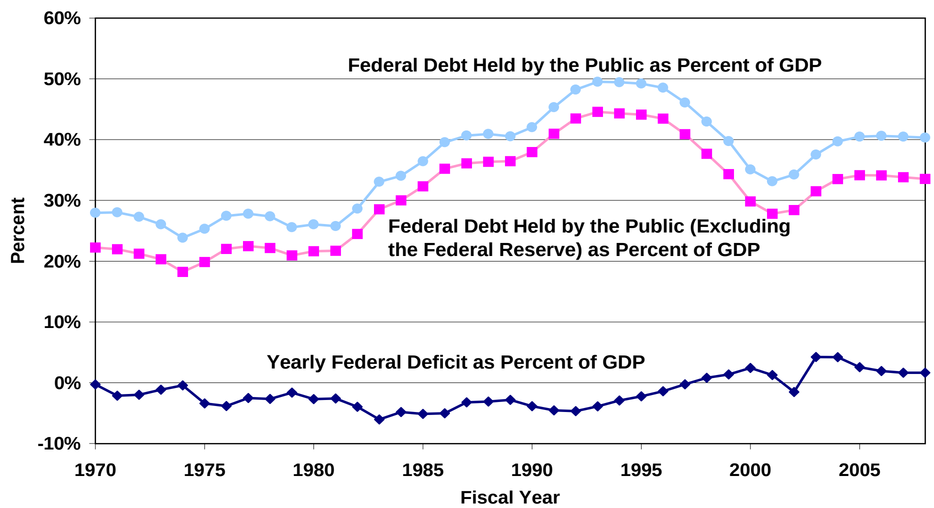
MID-SESSION REVIEW PROJECTS HIGHER FEDERAL DEFICITS, BUT NO NEED TO PANIC

The Administration has released its Mid-Session Review of the federal budget. It shows increased federal budget deficits relative to the February release. The increases are due largely to the weaker than hoped for economic recovery and spending on the war in Iraq. As the chart below shows, although the deficits are large in nominal terms, they are not unusually big as a share of GDP following a recession. They are projected to decline quickly as a share of GDP as the recovery progresses, especially if the government adopts a modicum of spending restraint. The deficits are not large enough to have any significant adverse effect on interest rates or on the economy. Debt as a share of GDP will rise only modestly, and will remain well within historic norms.

The deficit in perspective. As can be seen in Table 1, the Mid-Session Review projects deficit increases.

The deficit is projected to jump to $455 billion in fiscal 2003 and to $475 billion in fiscal year 2004, but it would be halved by fiscal year 2008 under the Administration's budget proposals. As a percent of GDP, the deficit numbers are less alarming. They would represent 4.2 percent of GDP in FY 2003 and FY 2004, and only 1.7% in FY 2008. These are the policy deficits, including the planned $400 billion in spending on prescription drugs, which boosts the deficit, but also including Administration proposals to restraint the growth of discretionary spending in the future.

Chart 1 Federal Deficit and Federal Debt Held By The Public As Percentages of GDP, 1970 - 2008



Sources: Data for 1970-2002 from U.S. Budget, Historical Tables; and estimates for 2003-2008 from OMB's Mid Session Review. (To calculate debt held by the public excluding the Federal Reserve, debt held by the Fed was estimated for 2003-2008.)

Table 1 Changes from the 2004 Budget
(In billions of dollars)

	2003	2004	2005	2006	2007	2008
2004 Budget Policy Deficit	-304	-307	-208	-201	-178	-190
Economic and technical reest.	-66	-95	-80	-58	-53	-50
Iraqi war supplemental	-47	-20	-1	*	*	*
2003 jobs and growth act	-13	-36	1	30	29	24
Other legisl. and policy changes[1]	-26	-17	-16	-9	-10	-10
Total Changes	-151	-168	-96	-37	-35	-36
Mid-Session Review Policy Deficit	-455	-475	-304	-238	-213	-226
Budget Deficit as Percent of GDP	4.2%	4.2%	2.6%	1.9%	1.6%	1.7%

Source: Budget of the U.S. Government, FY 2004, Mid-Session Review, Table 1 and Chart 1.

* $500 million or less.
[1] Includes debt service on all policy changes.

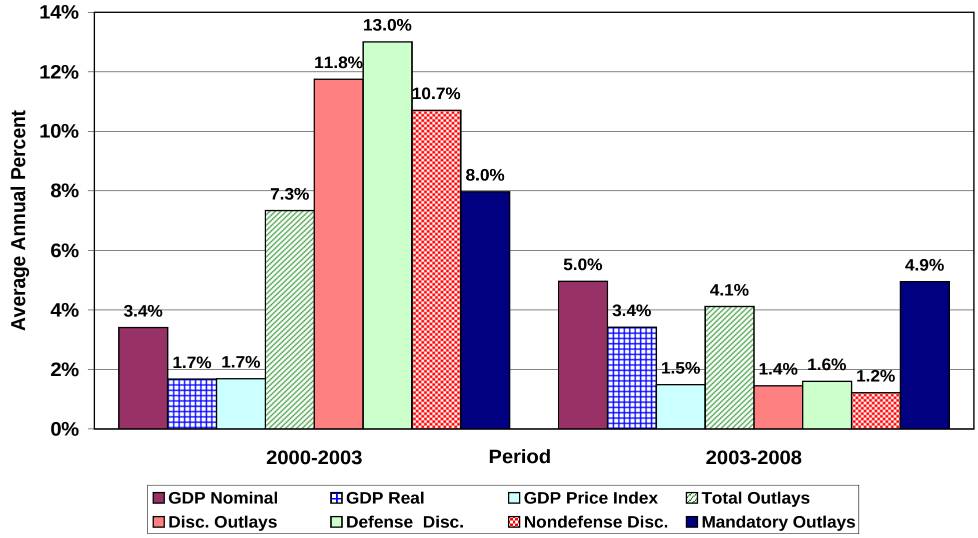
Sources of the deficit. The bulk of the increase in the deficit since the February Budget — over 71 percent of the 2003-2004 increase — is due to weaker than hoped for economic growth and the costs of the Iraq war. A weak economy reduces the growth of federal revenue and raises safety-net spending. Recession and war are two good reasons for increasing federal borrowing. So long as the deficits do not become chronic, the transitory increase in borrowing is easily sustainable.

As Chart 2 shows, discretionary spending has been surging from 2000 to 2003. It is up nearly 40 percent in three years, at nearly a 12 percent annual rate, while inflation has been averaging less than two percent. Over the same period, nominal GDP has grown less than 11 percent, or about 3.4 percent per year (about half real growth, half inflation). The surge in discretionary spending is not just for defense. Both the defense and non-defense components of discretionary spending have been soaring, defense at an average of 13 percent per year, and non-defense discretionary spending at nearly 11 percent per year. The surge in defense spending after 9/11 is understandable. The surge in non-defense discretionary spending is inexcusable.

The 2003 Jobs and Growth Act tax reduction accounts for a very small portion of the increase in the deficit from the February projections, adding only $13 billion to the deficit in FY 2003 and $36 billion in 2004, and in its final form reduces the deficit forecast in the outyears. The 2001, 2002 and 2003 tax cuts, while reducing federal revenues, have had the effect of reducing the severity of the recession and speeding the recovery. These acts have cost substantially less than their static revenue estimates would imply. If revenues are to grow strongly in the future, and if recession-related safety-net spending is to slow, then the growth features of these tax reductions should not be repealed, and, indeed, should be extended.

The reduction in the deficit projected in 2005 through 2008 stems from two factors: the improvement in the economy and the restraint of discretionary spending projected in the Administration budget. Both assumptions are important. The economy is forecast to grow at just over 3 percent a year in real terms through 2008, quite a modest assumption by historical standards following a recession. This scenario is especially plausible if the growth-related tax changes are extended. The Administration proposes to hold discretionary domestic spending growth to roughly 1.2 percent per year through 2008, slightly below the projected rate of inflation (1.5 percent per year for the GDP price deflator). The spending restraint

Chart 2 Federal Spending Has Risen Much Faster Than National Output And Prices



The annual rise in Discretionary Spending has been 8.1% over the last 3 years -- faster than the growth of nominal GDP, and well above inflation. Discretionary Spending needs to be controlled. The 2000-2003 rate of increase in Defense Outlays is presumed to be temporary.

is reasonable, given the enormous increase in the base level allowed in the last three years. The spending restraint would also help the private sector to expand by reducing the preemption of manpower and material by the federal government. The halving of the deficit will occur even with the Administration's proposals to extend many of the expiring provisions in the 2003 Tax Act. One provision the Administration does not propose extending is the enhanced depreciation allowances (50 percent expensing) that are now slated to expire at the end of 2004 (the end of 2005 for some longer lived property). Economic growth is so important for a good budget outcome and for the welfare of the general public that we would prefer to see this growth incentive continued, even if it meant a small increase in the outyear deficits.

Deficits and interest rates. The amount of financial assets outstanding in the world — stocks; corporate and government bonds, notes, bills and commercial paper; mortgages; bank loans; etc. — is approaching $100 trillion in this decade. Modest additional borrowing by the Federal government would not increase this pool of debt by a significant amount, nor affect the prices of the assets or their rates of return, e.g., the interest rate. For example, adding an additional trillion in U.S. government debt to this large pool, about a one percent increase, would have a minimal effect on global and U.S. interest rates. The best estimates we have seen of the impact on long term interest rates would be a rise of no more than a quarter of a percentage point. For example, corporate bonds previously yielding about 6% might rise to 6.25%, which is not enough to dampen investment spending to a significant degree. Certainly, the enhancement of depreciation allowances and the reduction in the double taxation of corporate income enacted in 2003 will do far more to encourage investment than the budget deficit will do to reduce it. Indeed, the modest rise in interest rates in the last week (which still leaves them at amazingly low levels) probably incorporates the full effect of the projected deficits, as well as showing increasing optimism that the economy is improving.

There will be additional increases in interest rates as the economic recovery accelerates. That, however, will be a good sign, because it will signal an increase in expected returns on business investment, which is necessary to stimulate the additional business spending that will drive the expansion. It is when expected returns on capital investment go up, and business spending goes up, that the economy will recover. When those returns rise, the returns on financial instruments must rise to keep pace. In fact, it is through higher returns on stocks and bonds that businesses "share" the higher returns on their physical capital with savers in order to attract funding for the expanded investment. Far from indicating an economic problem, a rise in real returns on financial assets suggests a robust economy. There may also be an increase in interest rates if inflation reemerges. That would be unfortunate, as it would dampen investment incentives and injure savers. The Federal Reserve should not overdo its "stimulus".

Dealing with the deficit. We do not mean to applaud deficits. Deficits hide part of the cost of government from the taxpayer/voters, and encourage overspending. They are not good policy for the long term. However, they do not generally damage the economy by unduly raising interest rates, and should not be used as an excuse to raise taxes in a manner harmful to economic growth.

Spending and regulation are the real measures of the drag of government on the economy. Whenever the government preempts labor and materials for its own use, those resources are no longer available for use by the private sector, and that is true whether the resources were paid for with tax money or borrowed funds. The deficit should be dealt with through spending restraint. Meanwhile, steps such as reducing tax rates to encourage people to supply more labor and capital services can help ease the burden of government by increasing the country’s productive capacity.

Stephen J. Entin
President and Executive Director

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.