After passing the House of Representatives last week, earlier today, the Senate passed a motion that all but guaranteed the passage of the Bipartisan Budget Act of 2013. It will face a final vote tomorrow and will thereafter be signed by the President into law. The deal, while small, is significant in that it is a step away from the political brinkmanship that has characterized the last several years. It marks the first bipartisan budget deal since 1986.

In addition to reducing fiscal policy uncertainty and removing the threat of a government shutdown in January, the budget deal increases discretionary spending authority by $44.8 billion in fiscal year 2014 and $21.6 billion in fiscal year 2015. This is equivalent to an increase of 0.3% of GDP in 2014 and 0.1% of GDP in 2015.

The increase in spending authority will turn into increased government outlays with a lag. The Congressional Budget Office (CBO) estimates that outlays will rise by $26.3 billion in fiscal 2014, $21.6 billion in fiscal 2015, $8.6 billion in fiscal 2016, and the remaining $5.9 billion in the following three fiscal years.

The 2014 fiscal year began in October of 2013 and ends in September. Prorating the CBO’s estimates for the calendar year, spending is likely to rise by around $30 billion in 2014, $20 billion in 2015 and $10 billion in 2016.

The impact of the deal on economic growth in any given year depends on the change in spending relative to the previous year and the estimated government spending multiplier – defined as the increase/decrease in GDP per dollar of increase/decrease in government spending.

There is a significant degree of uncertainty with respect to the size of government spending multipliers. The CBO’s analysis indicates a range of estimates for the fiscal multiplier of direct government spending that range between 0.5 and 2.5. According to the IMF’s analysis, the range is slightly smaller, from 0.4 to 2.0. The magnitude of the fiscal multiplier is likely larger in an economic environment characterized by elevated unemployment and low interest rates.

Our recently published Quarterly Economic Forecast assumes a fiscal multiplier of slightly greater than one. The estimated impact of the budget deal is to lift real GDP growth by around 0.3 percentage points in 2014. As the increase in spending relative to a non-budget-deal baseline will fall to $20 billion in 2015 and $10 billion in 2016, the deal will pose a modest drag on economic growth of around 0.1 percentage points through these years.
• The budget deal was also significant in what it did not include, namely an extension of emergency unemployment compensation. As these benefits expire, aggregate disposable personal income will be reduced by around 0.1% in 2014. Assuming a multiplier of around 1.0, this implies a reduction in economic activity of around 0.1 percentage points.

• Other unfinished business for Congress in the New Year includes passing a farm bill and a permanent fix to physician payments for Medicare, which was patched in the budget deal, but only for three months. Without new legislation, Medicare pay to physicians will drop 24% back to 1997 levels; a hit of around $15 billion annually or around 0.1% of GDP.

• One source of uncertainty that will remain is the statutory debt limit, which was not a part of the budget deal. On February 7th, the debt ceiling will be reinstated, requiring the Treasury to take extraordinary measures to avoid breaching its limit. Using these measures, the Treasury can likely push out the effective debt ceiling deadline out a few more months, but at some point it will have to be raised. Paul Ryan, the House Budget Committee Chairman has said that he will use the debt ceiling to extract more budget concessions.

• All told, the budget deal will ease some of the spending cuts set to take place next year. Fiscal drag is likely to fall from 1.3 percentage points in 2013 to around 0.5 percentage points in 2014. The reduction in federal fiscal drag in addition to rebounding spending by state and local governments is one reason that economic growth is expected to rise to 2.7% in 2014, from an estimated 1.8% in 2013. While the deal will pose modest drag on growth in 2015 and 2016 relative to our previous expectations, overall federal fiscal drag will continue to diminish over this time period, allowing the private sector recovery to gain a greater foothold.

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