OBSERVATION
TD Economics

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U.S. DEFICITS & DEBT:
PAST, PRESENT & FUTURE

Highlights

• The U.S. budget deficit is declining sharply. From 10.9% in fiscal 2009 and 6.8% in 2012, the Congressional Budget Office (CBO) projects the deficit to fall to 3.9% in 2013 and 2.1% of GDP by 2015.

• The CBO projects that the debt-to-GDP ratio will remain roughly unchanged over the next 10 years, edging down to 71% by 2023 from 72% in 2013.

• The fiscal cliff deal earlier this year made several previously temporary tax measures permanent. This has made the CBO’s baseline current-law projections a more reliable indicator of future deficits.

• Deficit and debt projections are highly sensitive to assumptions about economic growth and interest rates. Slower economic growth will require additional fiscal consolidation in order to stabilize the debt-to-GDP ratio.

• Modest additional fiscal consolidation is all that is necessary to stabilize the debt-to-GDP ratio over the next decade. The real challenge is in slowing entitlement spending in the decades that follow. Fortunately, as a result of deficit reduction measures already put in place, policy makers have breathing room to deal with this challenge.

You wouldn’t know it by the tone of the political debate, but there is good news on the U.S. budget. The deficit is shrinking rapidly. From an estimated 6.8% of GDP in 2012 and a record-setting 10.8% in 2009, the deficit is projected to fall to 3.9% in 2013. According to the Congressional Budget Office (CBO), the deficit is expected to decline even further in the next two years, reaching 2.1% of GDP by 2015. This is the most rapid improvement in the deficit since demobilization following the Second World War.

The improvement in the budget deficit has come even as economic growth has struggled to gain traction. Nominal GDP in 2013 grew by just 3.1% — the slowest pace in three years. Faster economic growth typically helps to close the budget deficits by boosting tax revenues through higher employment and corporate profits, while simultaneously lowering spending on income-security programs. However, the decline in the deficit over the last year has been mainly due to policy choices: the Budget Control Act (BCA) and sequestration, the expiration of the payroll tax cut, and the reversal of Bush tax cuts for individual income over $400,000.

Policies currently in place – sequestration and spending caps that were put in place under the BCA – are projected to lower discretionary spending to the lowest level on record over the next decade. As a result of these cuts and projections of faster economic growth, the deficit is projected to decline even further in the next two years, reaching 2.1% of GDP by 2015. This is the most rapid improvement in the deficit since demobilization following the Second World War.

CHART 1: FEDERAL BUDGET BALANCE

Source: Congressional Budget Office
Two of the biggest of these temporary tax provisions were the Bush tax cuts (2001 and 2003) and the Alternative Minimum Tax (AMT). The Bush tax cuts originally had a sunset of 2010, but were extended to 2012. The AMT, which had exemption amounts that were not indexed for inflation, required patches on an annual basis in order to avoid drawing a greater number of middle-income earners into higher tax brackets.

Both of these measures were made permanent with the resolution of the fiscal cliff in early 2012. In the case of the Bush tax cuts, tax rates were made permanent on all but the highest income bracket. As for the AMT, exemption amounts were indexed to inflation, thereby making future patches unnecessary.

As a result of these changes, the CBO’s baseline is now a more accurate depiction of the likely evolution of U.S. debt and deficits. To be fair, the CBO’s baseline projection still includes the expiration of a number of spending and tax elements that have, in the past, been extended. The biggest of these is the “doc-fix,” which prevents a near 25% drop in Medicare reimbursement rates to physicians. However, these are small in comparison to the previous temporary measures that made the U.S. budget debt and deficit look much more sustainable than it was in reality.

Importantly, both the Republican controlled House of Representatives and the Democratic controlled Senate have based their budget plans (discussed in a later section) on the CBO’s baseline projections. The CBO baseline is therefore the best place to start the discussion of future budgets.

More certainty on revenues as fiscal cliff deal made tax rates permanent

The CBO’s baseline budget projections are based on the assumption that current laws remain in place over the projection period. In the past, this assumption has tended to paint a rosier picture for the deficit than what actually played out. This was not due to errors in the CBO’s analysis, but rather reflected policy makers’ unwillingness to allow temporary tax or spending measures to expire. Naturally, these extensions worsened the deficit.
Slower economic growth & higher interest rates pose risk to deficit

The CBO’s baseline budget projection (as well as the House & Senate budgets) is notable in its assumptions for a marked acceleration in economic growth. From 3.0% in 2014, real GDP growth in the CBO baseline is expected to accelerate to 4.1% in 2015 and 4.4% in 2016. With inflation expected to average close to 2%, this leads to nominal growth averaging 6.4%. The acceleration in economic growth leads to a swift rise in revenues, which are aided both by the pace of economic growth and the move back to full-employment, which raises revenues as a share of GDP.

The economic growth assumptions made by the CBO are faster than the consensus of market economists as well as TD Economics’ forecasts. We expect real GDP growth of just over 3.0% over the next three years, which corresponds with nominal GDP growth of just over 5.0%. For the next decade as a whole, we expect nominal GDP growth to average 4.6%, about 0.2 percentage points below the CBO’s forecast. While this is not a material deviation, it does imply slower revenue growth and larger deficits. Holding spending assumptions unchanged, this would result in deficits that are 0.3% of GDP larger than the CBO’s baseline.

Put another way, given slower economic growth, additional spending reductions (or tax increases) of 0.3% GDP will be necessary to reach the CBO’s baseline deficit projection. However, this is not the end of the story. Slower economic growth and larger deficits hits the debt-to-GDP ratio twice by raising the numerator and lowering the denominator. Holding the CBO’s interest rate assumptions unchanged, alongside slower economic growth, the debt-to-GDP ratio would reach 75% instead of 71%.

This may not look like much on the surface, but it serves to demonstrate how minor differences in growth assumptions equate to an increase in debt. That four percentage point difference equates to just under $700 billion dollars.

Likewise, given the size of the accumulated debt, the deficit is highly sensitive to increases in interest rates. For every 0.1 percentage point increase in the effective interest rate on government debt, the annual deficit rises by 0.1 percentage points of GDP. Arguably, a slower pace of economic growth would also slow the rise in interest rates, but the CBO’s assumptions on both long- and short-term interest rates are very similar, if not slightly more optimistic (rates rise slower) than TD’s forecasts.

The bottom line is that future deficits and debt will depend importantly on the growth rate of the economy and the level of interest rates. Even with an acceleration in economic growth over the next several years, revenue growth could prove disappointing. In the absence of changes to spending, this will result in modestly higher deficits. At the same time, if interest rates are even just slightly higher than expected, the deficit will also move higher.

House and Senate budget plans offer guideposts to future deficit reduction

With economic growth doing all it can to reduce deficits, any further improvement will require either legislative changes to tax rates or deductions or cuts in spending. Earlier this year, separate budget bills were passed by the House
of Representatives and the Senate. While neither of these documents was passed into law, they serve as goal posts for the range of policy options currently being considered to cut the deficit.

What is striking about the two plans put forward in Congress is not how different they are, but rather how similar they are. For example, over the next decade, Democrats and Republicans would spend the exact same amount – 10.9% of GDP – on national defense and age-related entitlement programs (Medicare and Social Security). Even on taxes, the two documents are relatively similar. The Senate budget would see revenues as a share of GDP average 19.3% of GDP over the next 10 years, while the House budget would see revenues average 18.8% of GDP.

Where the documents differ is on how much to spend on everything else. While the Senate budget would keep spending close to historical norms and broadly in line with the CBO’s baseline projection, the House budget would cut this spending by roughly two percentage points of GDP over the next decade. The difference is roughly split between health care spending outside of Medicare and non-health care spending.

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The long-term economic costs and benefits of different spending paths are outside of the scope of this paper. However, the House budget plan is notable in that most of its cuts are front loaded. Relative to the CBO’s baseline, the House budget would spend 1.6% of GDP less in 2015 and 2.0% less in 2016 (excluding interest payments). The fiscal drag associated with these reductions would likely be significant enough to slow the pace of GDP growth. Given the relatively optimistic economic growth assumptions already imbedded in the baseline, this increases the risk that revenue growth comes in slower than expected, and therefore deficits are larger than the House budget plan predicts.

The Senate plan, on the other hand, leaves spending broadly in line with the CBO’s baseline. As a result, it contains less up-front fiscal drag. However, as noted with respect to concerns surrounding the CBO baseline, without some additional consolidation it will also likely prove insufficient to stabilize the debt-to-GDP ratio over the next decade.

Entitlements will take more of the pie, but there is still time for reform

With modest additional fiscal consolidation, it is possible to stabilize the debt-to-GDP ratio over the next decade. Thereafter, the trend becomes unfavorable, rising steadily to 100% of GDP by 2038 and a whopping 245% of GDP by 2088. The reason for this is straightforward. As a share of GDP, spending on entitlements – Medicare, Medicaid, and Social Security – is expected to rise by 4.7 percentage points by 2038 and by an incredibly onerous 10.9 percentage points by 2088.

Three factors are behind the growth in entitlement spending: population aging, excess cost growth in health care, and expansion of Medicaid and exchange subsidies as part of the Patient Protection & Affordable Care Act (PPACA). According to the CBO’s long-run projections, between 2023 and 2038, 61% of the growth in entitlement spending will be due to population aging, 30% will be due excess cost growth, and 9% will be due to provisions of the PPACA.

There is some reason for optimism on these long-run
projections. Spending on health care has slowed dramatically over the past five years. Growth in Medicare spending per beneficiary from 2008 through 2011 ran at roughly half the pace of the previous five years. In 2011, (the most recent year data is available) overall health spending grew at just 3.9%, in line with growth in nominal GDP. Recent studies attribute the slowdown in health care spending on a number of factors including increased cost sharing, changes in enrollment toward younger healthier populations, as well as slower inflation and economic growth.

The future growth in health care spending is uncertain, but as result of recent trends, the CBO has lowered their projections for excess health care cost growth from previous forecasts. Nonetheless, it is still expected to be a major driver of long-run deficits. Should policies manage to slow the growth in health care spending per capita, it will go a long way to reducing future deficits.

However, even if per-capita health care expenditures can be brought in line with per capita GDP growth, the impact of population aging can not be tackled without more substantial reforms. According to the CBO, population aging alone will add 2.5 percentage points of GDP to entitlement spending over the next 25 years. Given the reductions in discretionary spending that have already been put in place, there is little extra juice to squeeze out of the rest of the budget in order to pay for age-related growth in entitlement spending.

In all likelihood, solving the long-term budget deficit will require reforms to these programs. Given that people plan their saving and retirement around the expectation that federal government programs will continue in their current form, any changes to these programs should be done well in advance. The good news is that the stabilization in the debt over the next decade gives breathing room to policy makers to make these changes.

**Bottom Line**

The U.S. budget deficit has improved dramatically over the last three years. With faster economic growth, the deficit is set to improve further over the next three years. After that, increases in interest costs and an aging population will once again exert upward pressure on the deficit.

The upside risk to the budget deficit and debt in the near-term is that economic growth comes in slower than expected. Based on our assumptions for economic growth, stabilizing the debt-to-GDP ratio will require an additional 0.3% of GDP in spending cuts or tax hikes over the next decade. However, given the adjustments already made and a private-sector operating closer to full-potential, this is manageable.

The challenge over the longer-term will be dealing with population aging and growth in health care spending that is likely to outpace growth in the overall economy. There is some good news on health care costs over the last few years. However, even without excess cost growth, there is no getting around the impact of an aging population on the budget deficit. This will require more substantial changes to entitlement spending and/or increases in revenues over the longer term. Fortunately, as result of deficit reduction measures already put in place, there is time to make these changes.

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Endnotes

1 All years quoted are fiscal years.

2 The effective interest rate on debt is defined as total interest payments divided by total debt in the previous year.

3 Excess cost growth is defined as the growth in age-adjusted health care spending per capita over and above per-capita nominal GDP.