Budget Deficits Continue to Surprise on the Low Side!

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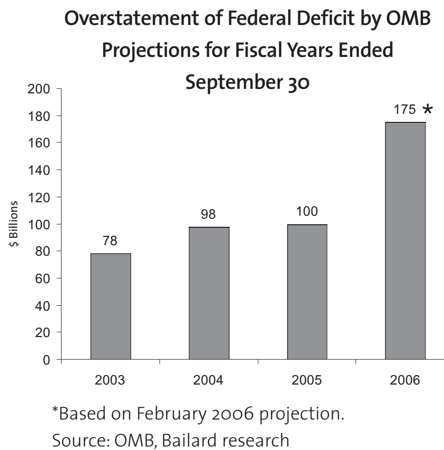
What happened to those spiraling out of control deficits?

In July 2003, we wrote a topic paper titled, "The Federal Budget Deficit: Cause for Concern?" At that time, the Office of Management and Budget (OMB) was calling for federal budget deficits of $455 billion in 2003 and $475 billion in 2004. Many investors were concerned that the burgeoning deficits would lead to higher interest rates, lower economic growth and spiraling out of control deficits. Our conclusion was less alarmist. We noted that, "deficits are notoriously difficult to predict. Projections are no better than the assumptions on which they are based." We also concluded that the federal budget deficit was experiencing a "cyclical upswing due to economic weakness and increased defense expenditures. Nevertheless, the deficit appears to be manageable, particularly if the economy recovers, Congress exercises spending restraint and there are no unexpected geopolitical surprises." Our belief and history had shown us that "as long as it [the deficit] is cyclical rather than a structural problem, the federal budget deficit should not adversely affect interest rates or economic growth."

As indicated in the chart to the right, in recent years actual budget deficits have been significantly smaller than originally expected. The 2003 deficit was $78 billion less, the 2004 deficit was $98 billion less,

Overstatement of Federal Deficit by OMB Projections for Fiscal Years Ended September 30



*Based on February 2006 projection.
Source: OMB, Bailard research

the 2005 deficit was $100 billion less and the 2006 deficit was $175 billion less than projected by the OMB. The U.S. Treasury has just reported that the budget deficit for the fiscal year ended September 30, 2006 was $248 billion, down $71 billion from the $319 billion deficit realized for the 2005 fiscal year. 2006 was another example of how difficult it is to make budget projections in the short term and how multi-year projections may be no better than random number generators.

Why are projections often so wide of the mark?

Part of the problem is that the projections are highly sensitive to the economic assumptions put into these models. Small changes in economic growth, inflation and interest rate assumptions can swing deficits wildly.

Another issue is that the government uses static analysis in assessing the impact of tax and spending policy. Under this methodology, increases/decreases in spending are assumed to increase or decrease the deficit dollar for dollar. Tax increases/decreases are assumed to reduce or increase the deficit. Critics of static analysis argue that this forecasting methodology ignores the impact of changes in spending and taxation on economic growth. These critics would prefer to use a dynamic analysis that might capture, for example, the stimulative impact of tax cuts on economic growth and the size of the tax base before forecasting revenues.

Over the last few years, tax revenues have been higher than expected despite lower tax rates because economic growth, incomes and corporate profits have been much more robust and resilient than widely expected. Tax receipts last year increased 12% from the previous year. Since the tax cuts took effect in the fall of 2003, tax revenues have grown at 10.5% per annum.

It is fortunate that revenues have grown rapidly because there has been little spending restraint.

Last year, spending grew 7.4% to a record $2.65 trillion, about the same as the

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prior two years. This is well above the rate of inflation. Some of this spending is nondiscretionary or mandatory (Medicare, Social Security, interest expense) or hopefully transitory (expenditures for the war on terror, rebuilding after last year's hurricanes). However, discretionary spending (ex-defense), that spending that Congress can control, is rising at a just under a 7% pace. Should spending continue to increase, deficits are likely to widen out again next year if the economy slows.

Even though the deficit is shrinking, isn't government debt growing too rapidly and placing a heavy a burden on our children and grandchildren?

Total public U.S. Treasury debt outstanding has risen from $3.4 trillion in fiscal 1995 to $4.8 trillion in fiscal 2006. However, nominal GDP over that time has risen from $7.4 trillion to $13.3 trillion. As a result, debt-to-GDP has fallen from 46% to 36%. If deficits can be held to their current levels of 2% or less of nominal GDP, we believe the debt-to-GDP ratio should continue to fall and that the debt load will not have a significantly damaging impact on economic growth. The U.S. central government debt burden is well below the average of other countries. Japanese debt-to-GDP is over 150%, Italy 98%, France 54%, the U.K. 46%, Germany 40% and Canada 30%. This data suggests higher debt levels can be absorbed by modern governments while sustaining economic growth.

Although deficits and debt may not be major problems in the near term, what about the longer term outlook?

In the long term, the U.S. has a looming problem. Medicare and Social Security expenses related to the aging of America's population are poised to explode. In a recent speech, Fed Chairman Bernanke discussed the impending demographic time bomb, noting that longer life expectances and the retirement of the baby boom generation will force the nation to make difficult fiscal budget choices. "As the population ages," Bernanke said, "the nation will have to choose among higher taxes, less non-entitlement spending, a reduction in outlays for entitlement programs, a sharply higher budget deficit or some combination thereof." "Under current law, spending on ...[Medicare and Social Security] alone will increase from about 7% of U.S. gross domestic product today to almost 13% of GDP by 2030 and more than 15% of the nation's output by 2050."

Currently, all federal government outlays total 20% of GDP. If other spending remains the same relative to GDP, by 2050 higher Medicare and Social Security expenditures could result in federal government outlays absorbing as much as 28% of GDP. We believe such spending levels could have a detrimental impact on economic growth. Other major countries with comparable total government spending to GDP ratios generally exhibit slower growth and higher unemployment than the U.S. today.

As a result, the U.S. faces some difficult policy choices. To keep the relative size of government from growing, other spending may have to be cut significantly, since 15% of GDP goes to Medicare and Social Security, 1.5% of GDP goes to paying the interest on government debt and 4.5% of GDP goes to defense spending. To finance the increase in government spending solely from tax revenues, taxes would likely have to increase significantly from the current 18% of GDP to perhaps as much as 28% of GDP by 2050. Historically, however, it has been difficult to collect that much from taxpayers as the incentive increases to cheat, go underground and find creative means to avoid paying taxes.

Alternatively, the U.S. could reform entitlement programs by pushing out the retirement age, changing the methodology used to calculate benefits, further penalizing early retirement, doing greater means testing or levying the Social Security tax on all income levels.

So what's the bottom line? Is the U.S. economy headed for a train wreck?

I think the deficit problem is currently manageable. However, the policy choices we make will have an impact on how strong the U.S. economy is in the future. Wrong choices will likely mean slower growth and a higher hurdle. Right choices will likely mean faster growth and a lower hurdle. Since this is a politically challenging issue, I believe we are likely to end up with a holistic solution to the problem, with some entitlement reform, some increase in taxes, some reduction in spending and some deficits over time. I also believe the U.S. economy has been very resilient and is likely to remain so into the future.

Sources: Bailard Research, Oak Associates, Bloomberg, U.S. Federal Reserve, U.S. Department of the Treasury, Bureau of Public Debt, OECD.

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