The Federal Budget: The Deficit is Down But the Fundamental Challenge Remains

<u>Presentation to the Macroeconomic Advisers' Washington Policy Seminar</u>

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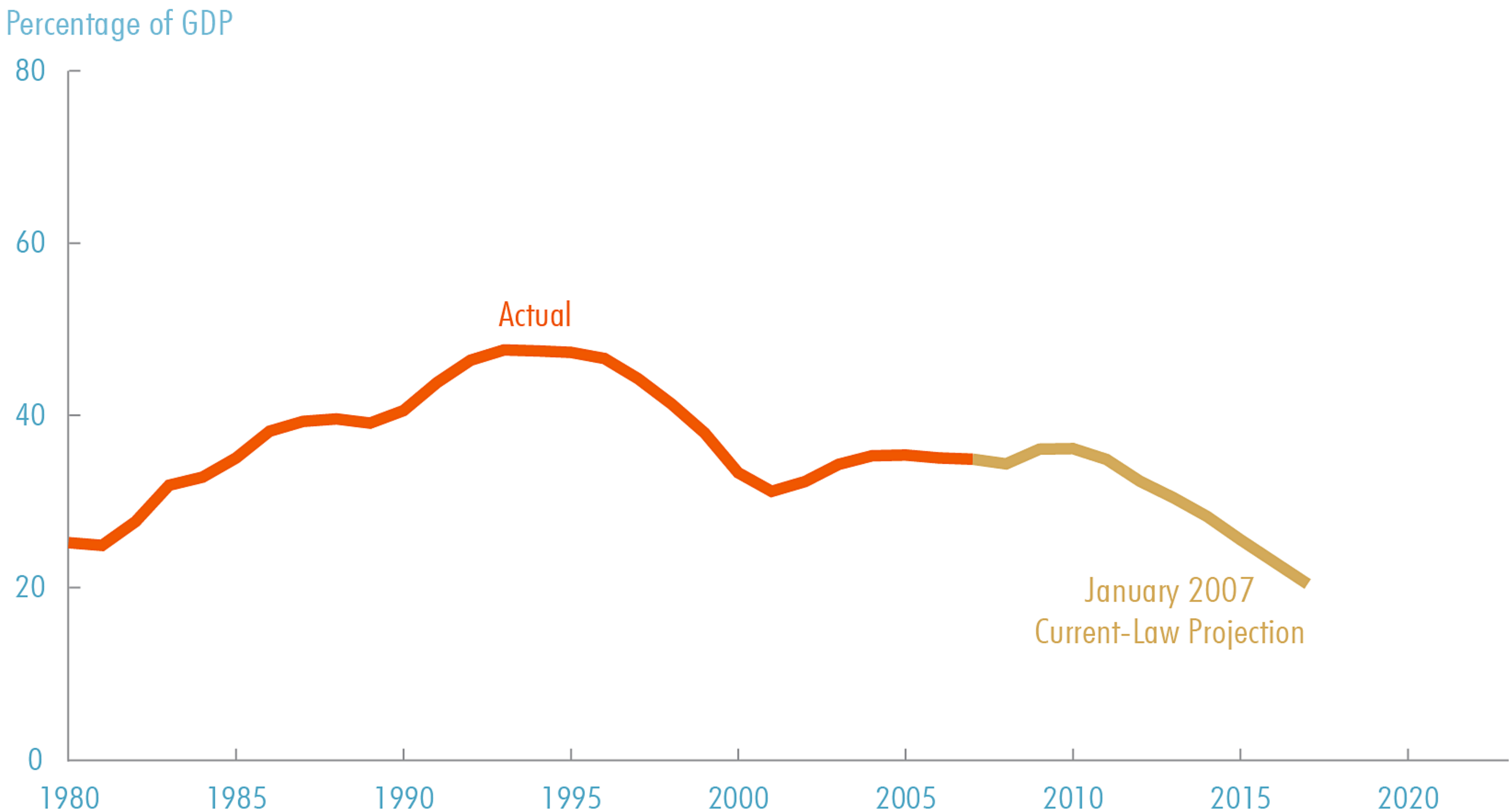
Note: Data in the figures reflect recent revisions by the Bureau of Economic Analysis to estimates of gross domestic product (GDP) in past years and CBO's extrapolation of those revisions to projected future GDP.

Federal Debt Held by the Public



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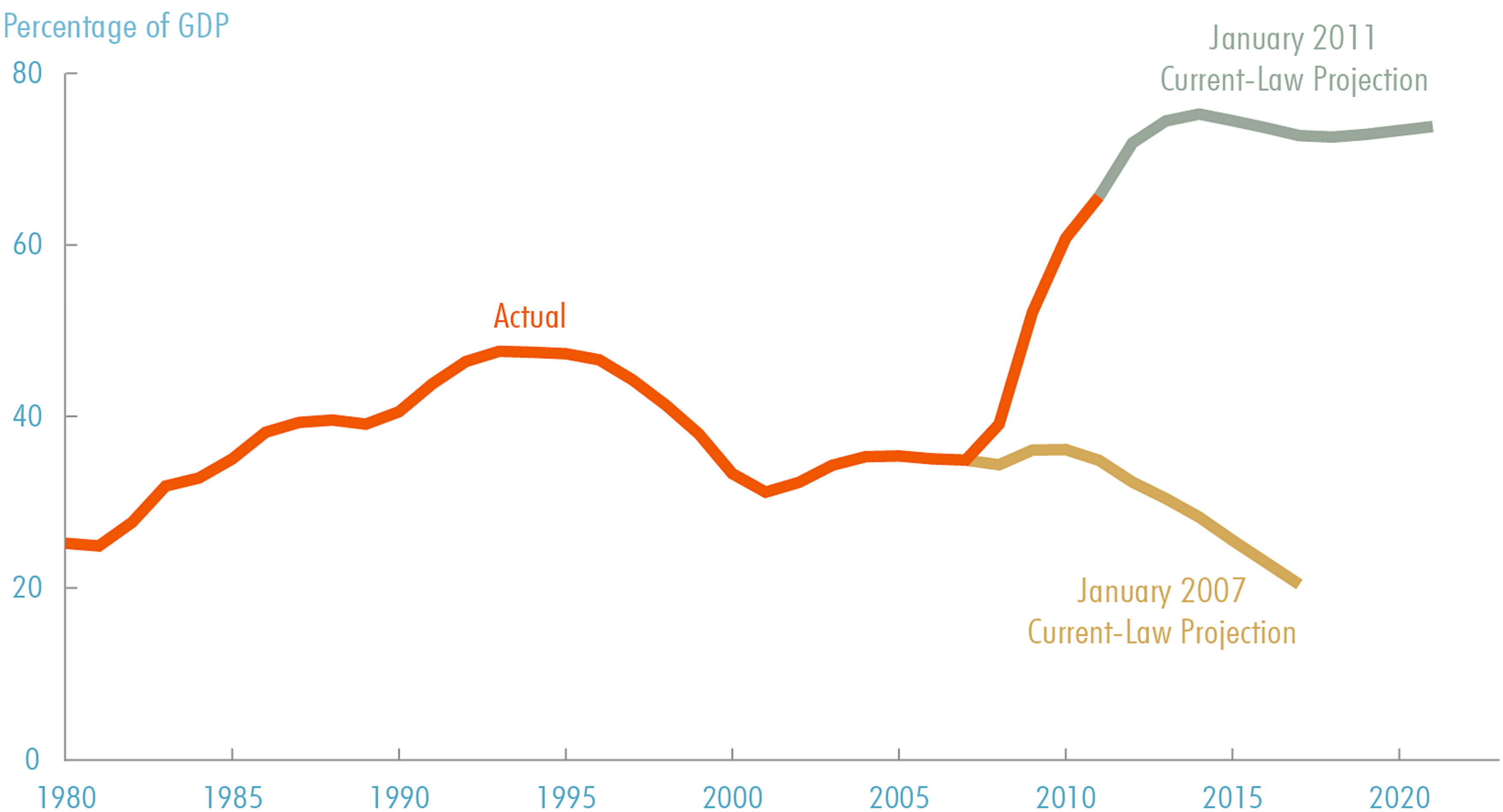

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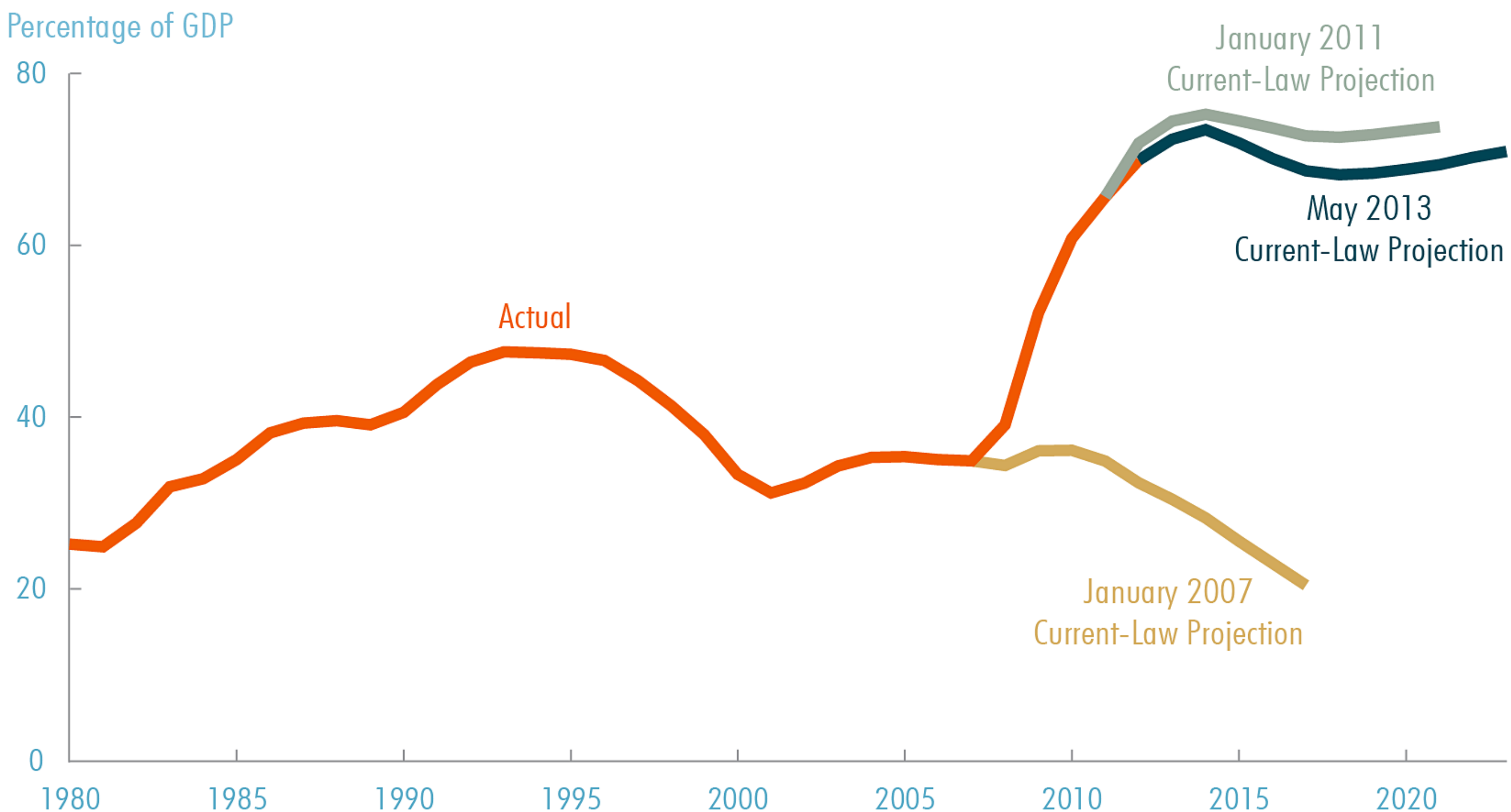
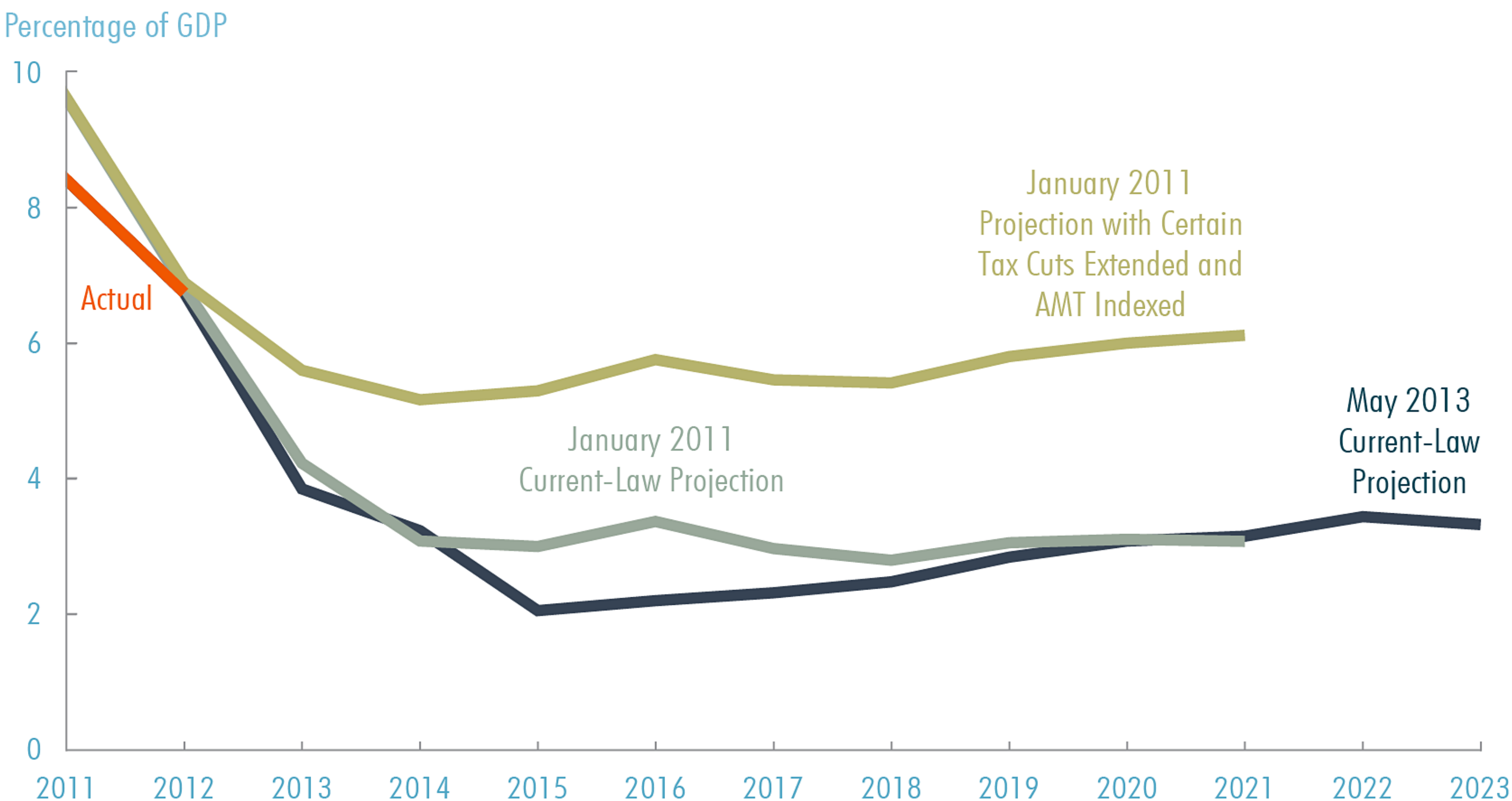
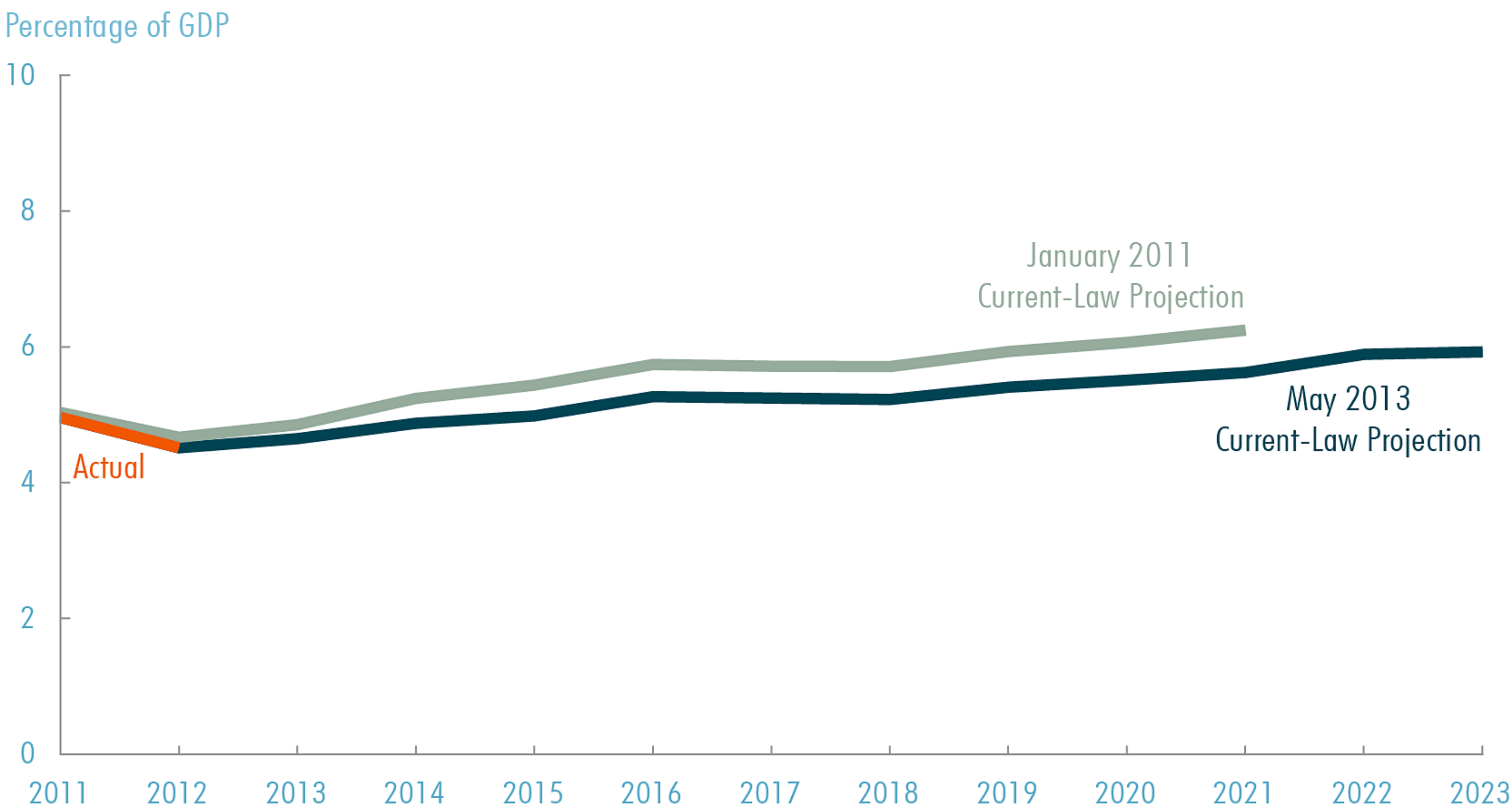


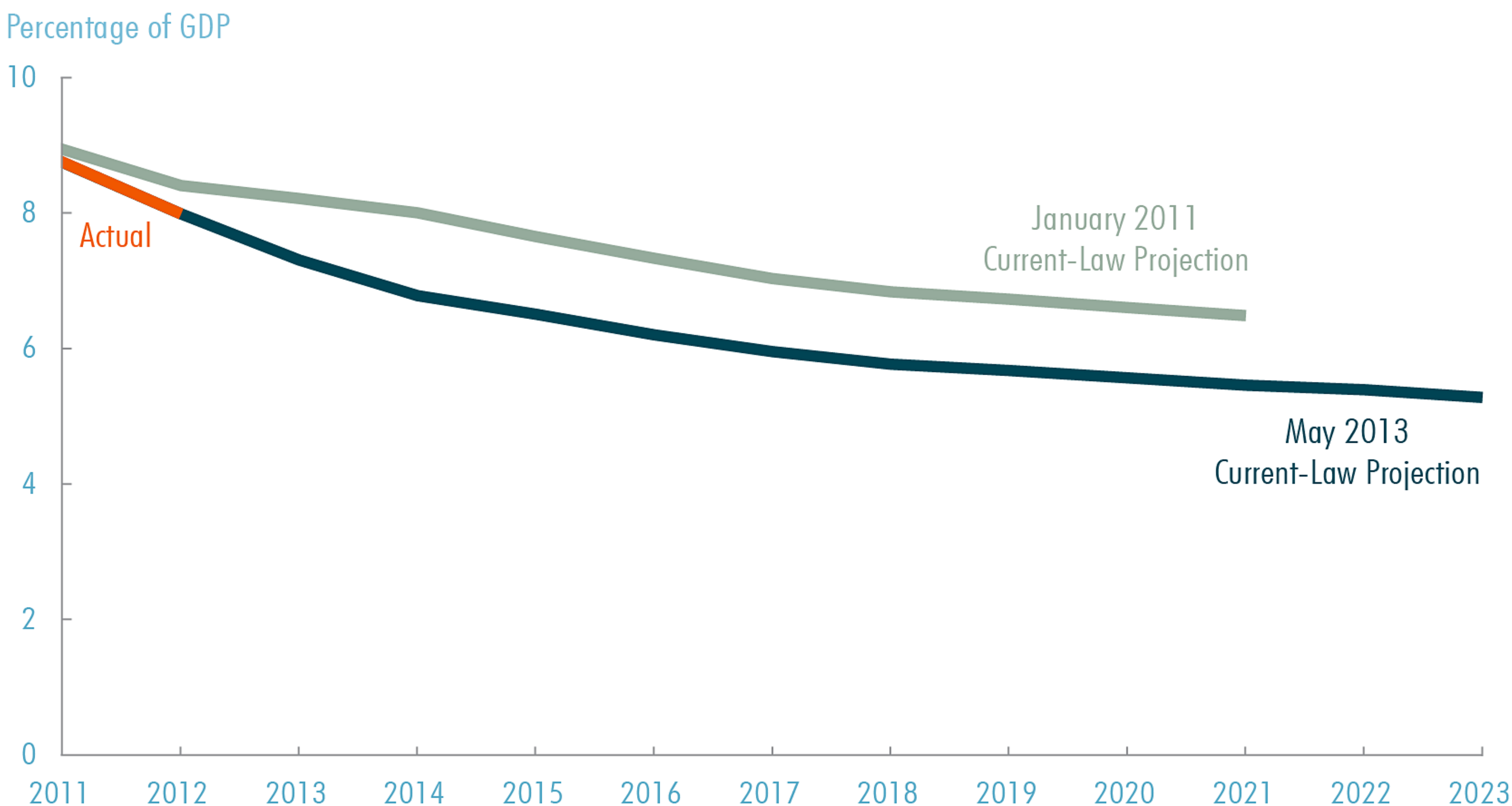
Federal Budget Deficit



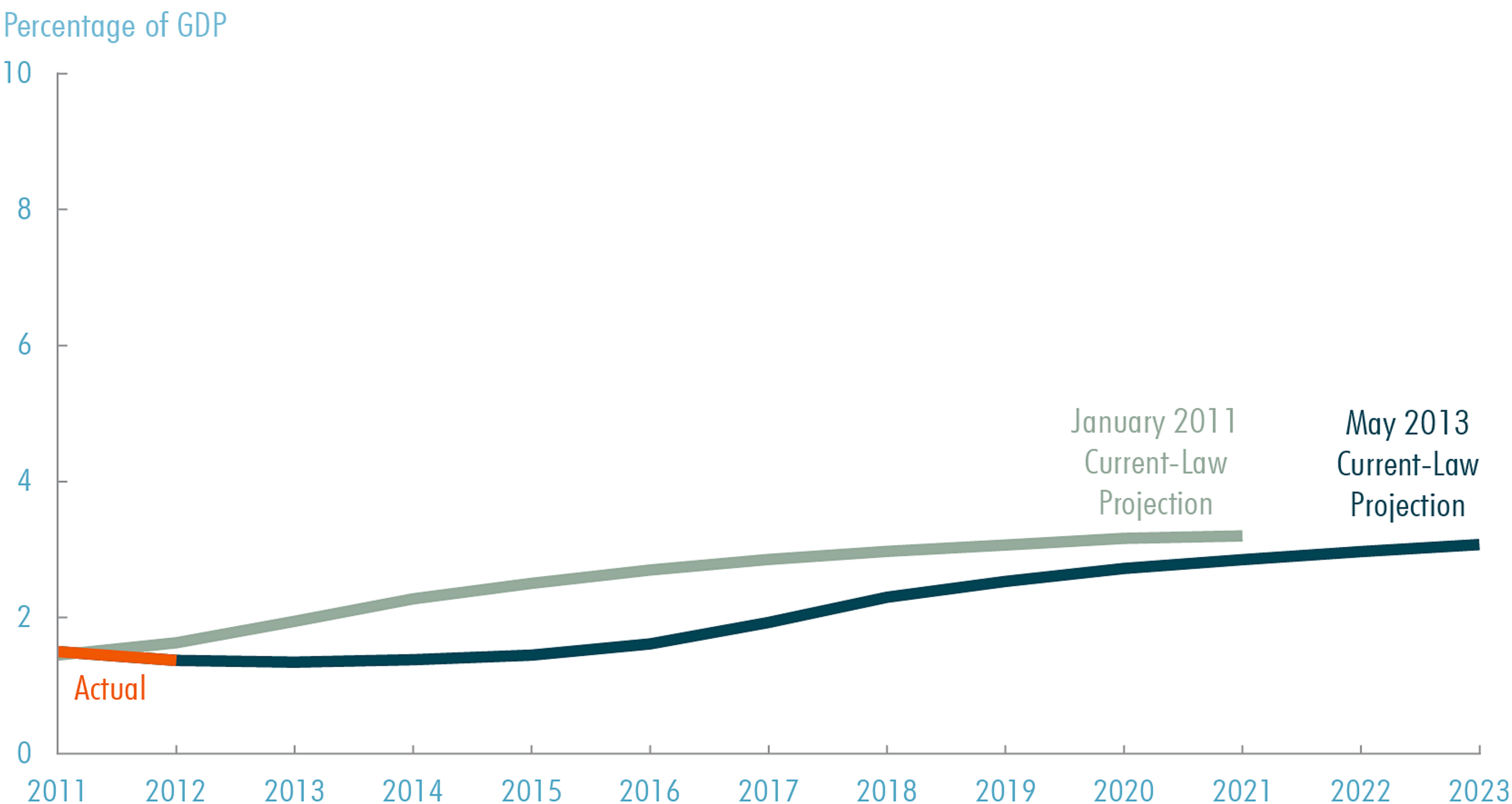
Federal Spending for Major Health Care Programs



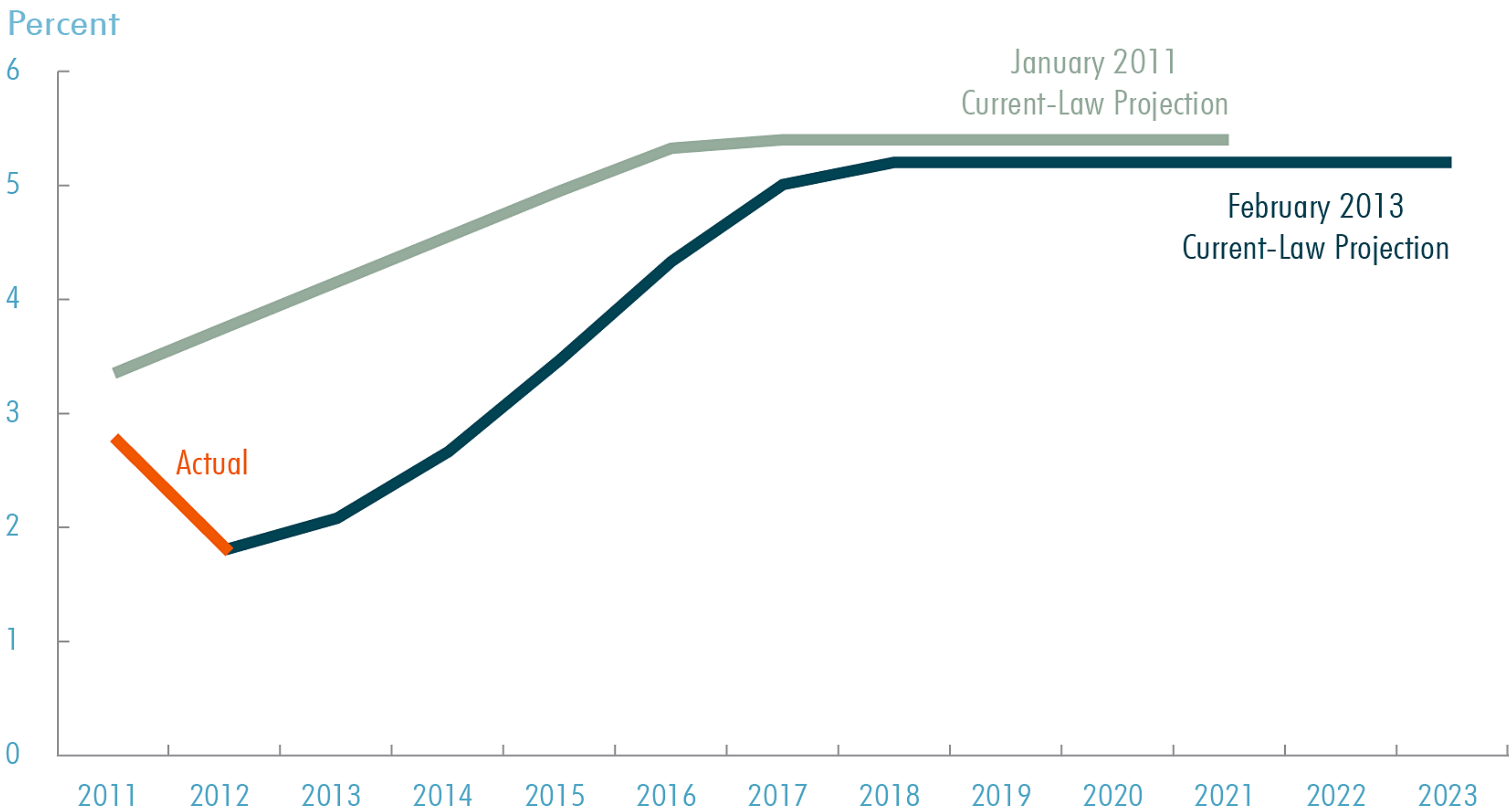
Discretionary Spending



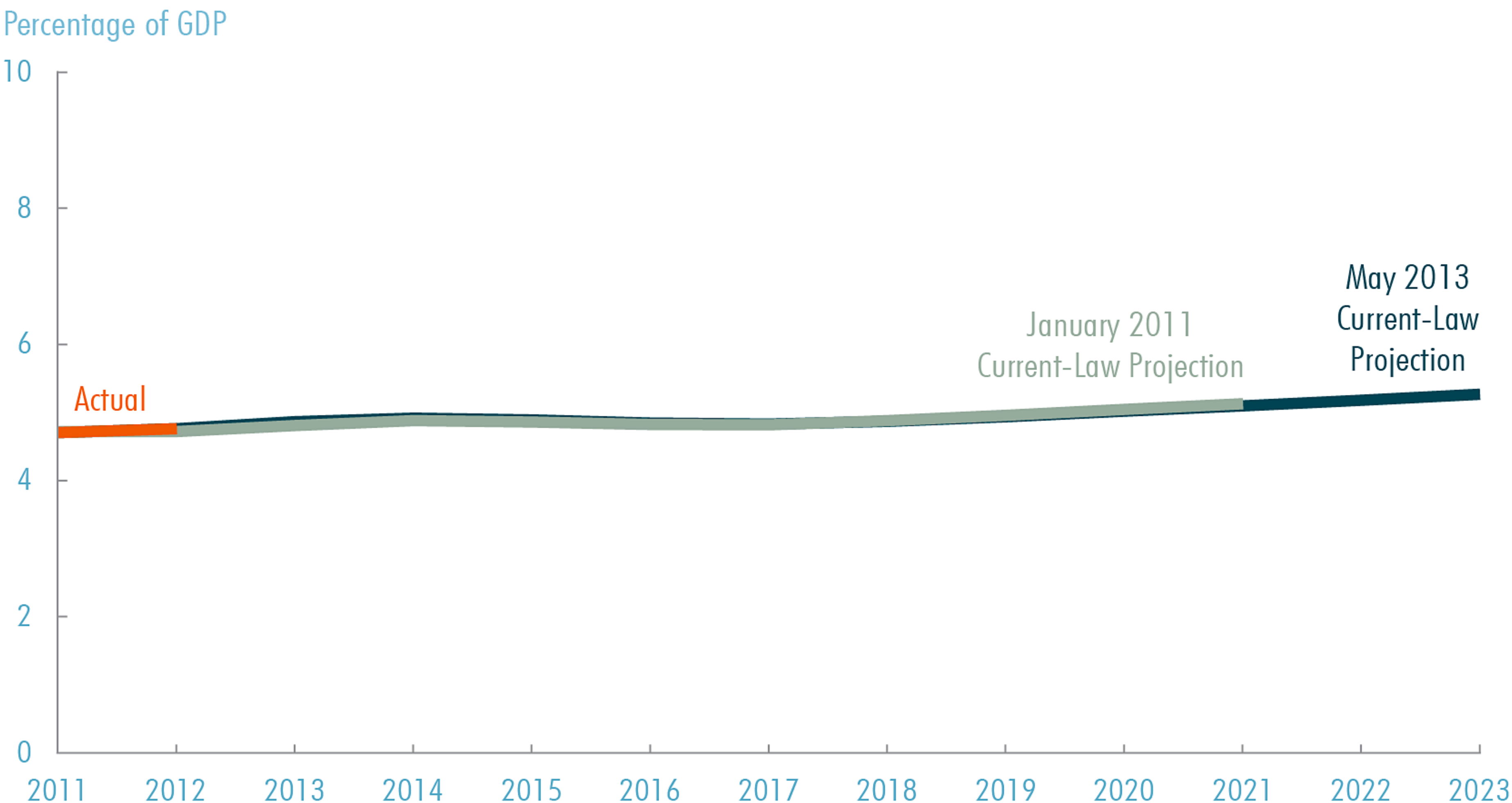
Net Interest Payments



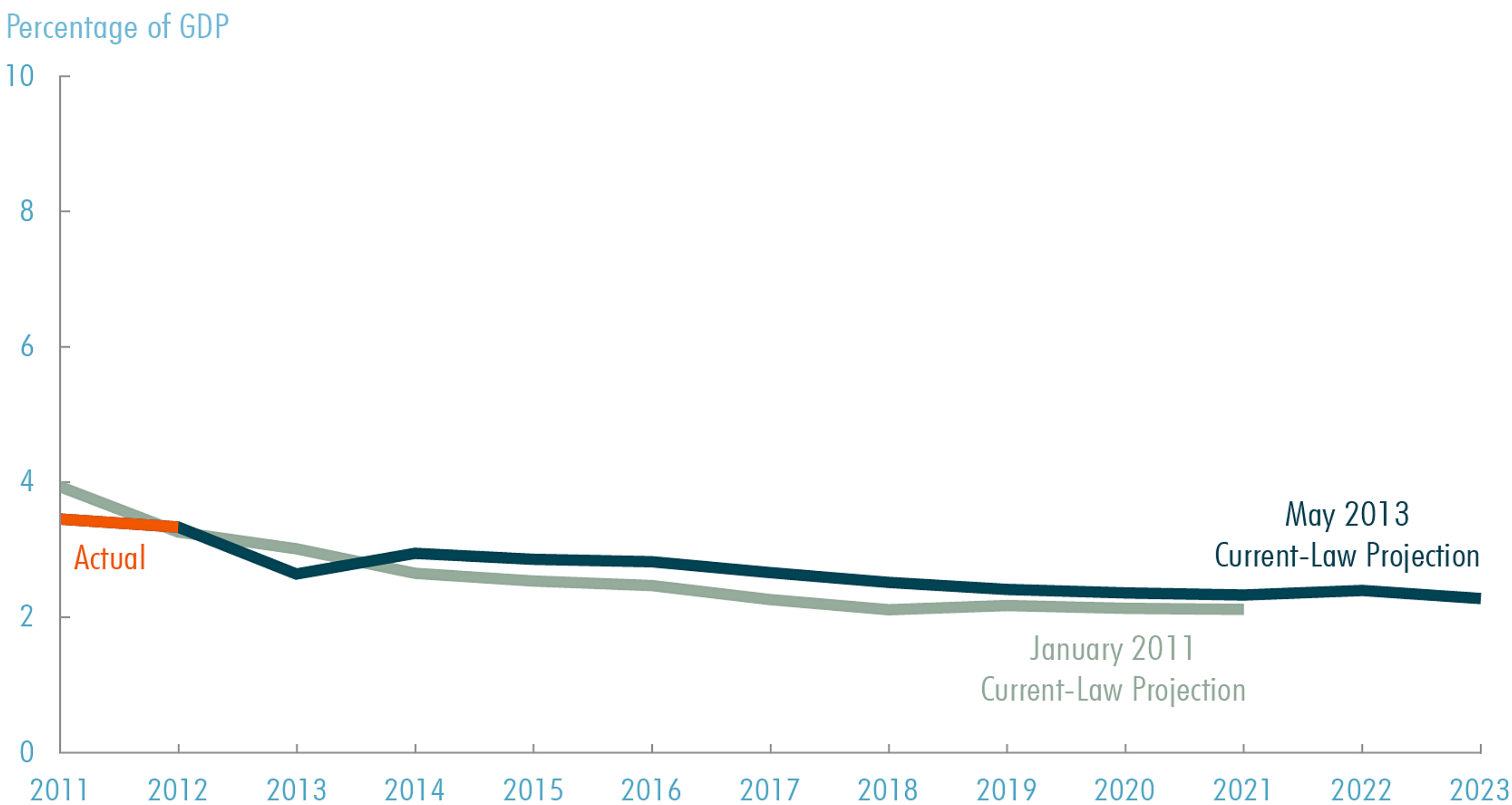
Interest Rate on 10-Year Treasury Note



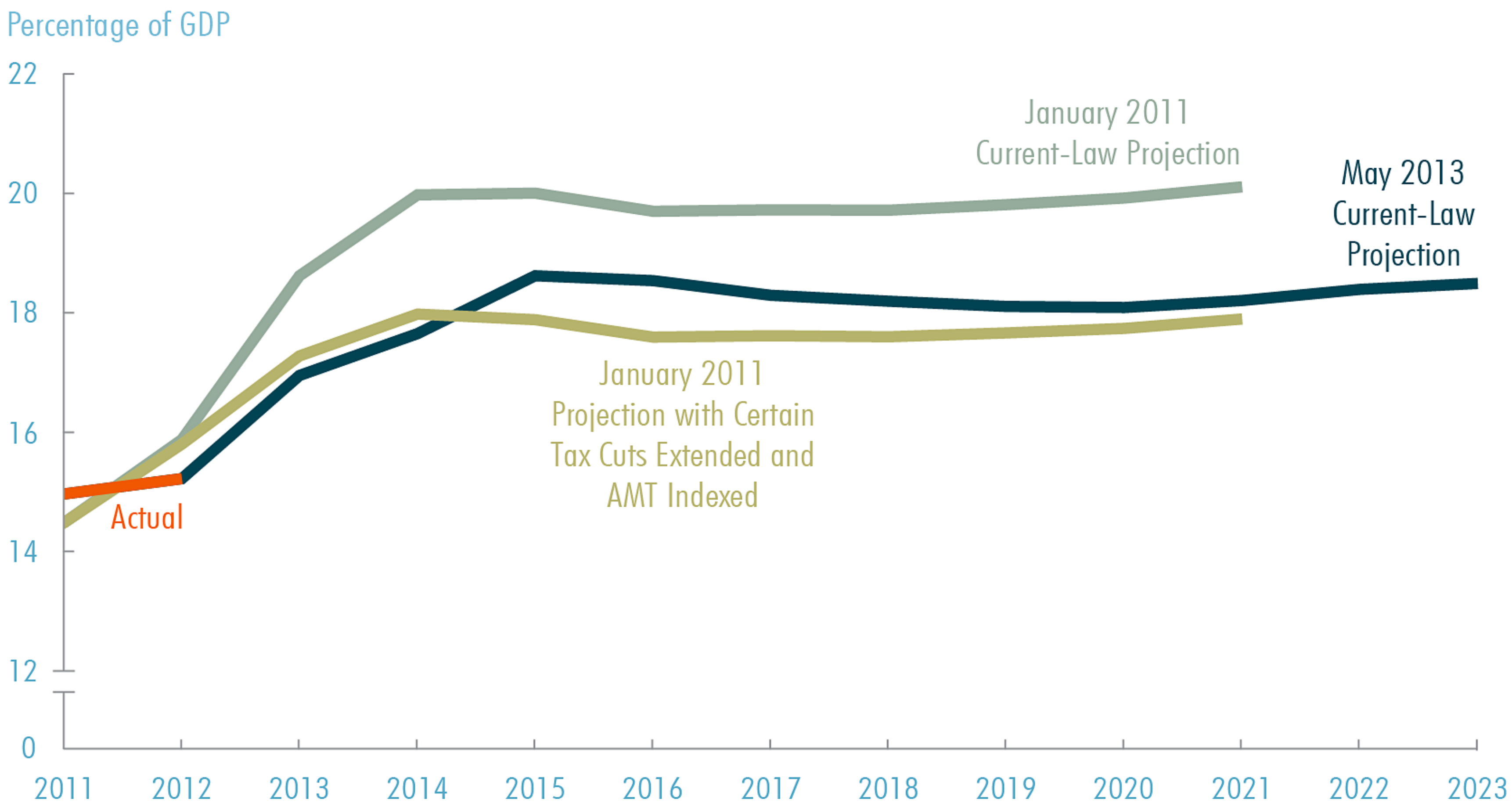
Spending for Social Security



Other Mandatory Spending



Federal Revenues

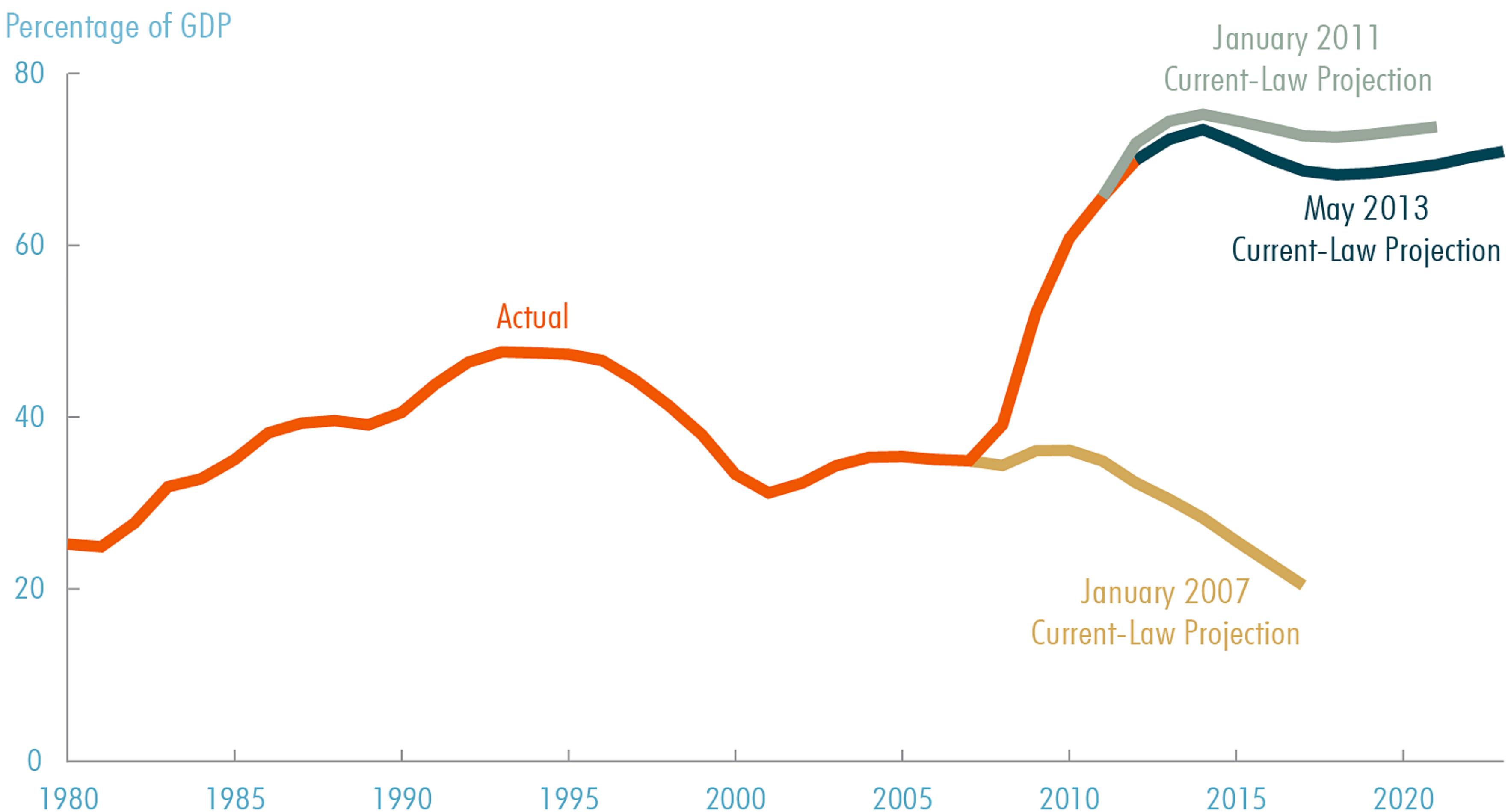


Revision to Projected Deficit in 2020

Between January 2011 projection assuming extension of certain expiring tax provisions and indexing of AMT, and May 2013 projection under current law:

	Percent of GDP
Spending	**-2.6**
Major Health Care Programs	-0.6
Discretionary Programs	-1.0
Net Interest Payments	-1.2
Social Security	0.0
Other Mandatory Programs	0.2
Revenues	**+0.3**
Deficit	**-2.9**

Federal Debt Held by the Public



The Choices Facing Policymakers

If policymakers wanted to take action to reduce future budget deficits….

Their key choices would be about:

- *How much* to reduce deficits,
- *Through what policies*, and
- *With what timing*.

How Much to Reduce Deficits

Economic analysis does not say what the optimal amount of federal debt is.

To give a sense of how much deficit reduction would be required to reach an illustrative target (not a recommendation!): Suppose that policymakers wanted to reduce debt from its current 73 percent of GDP to its 40-year average of 38 percent, and to make that reduction of 35 percent linearly over 35 years—that is, by 1 percent of GDP per year.

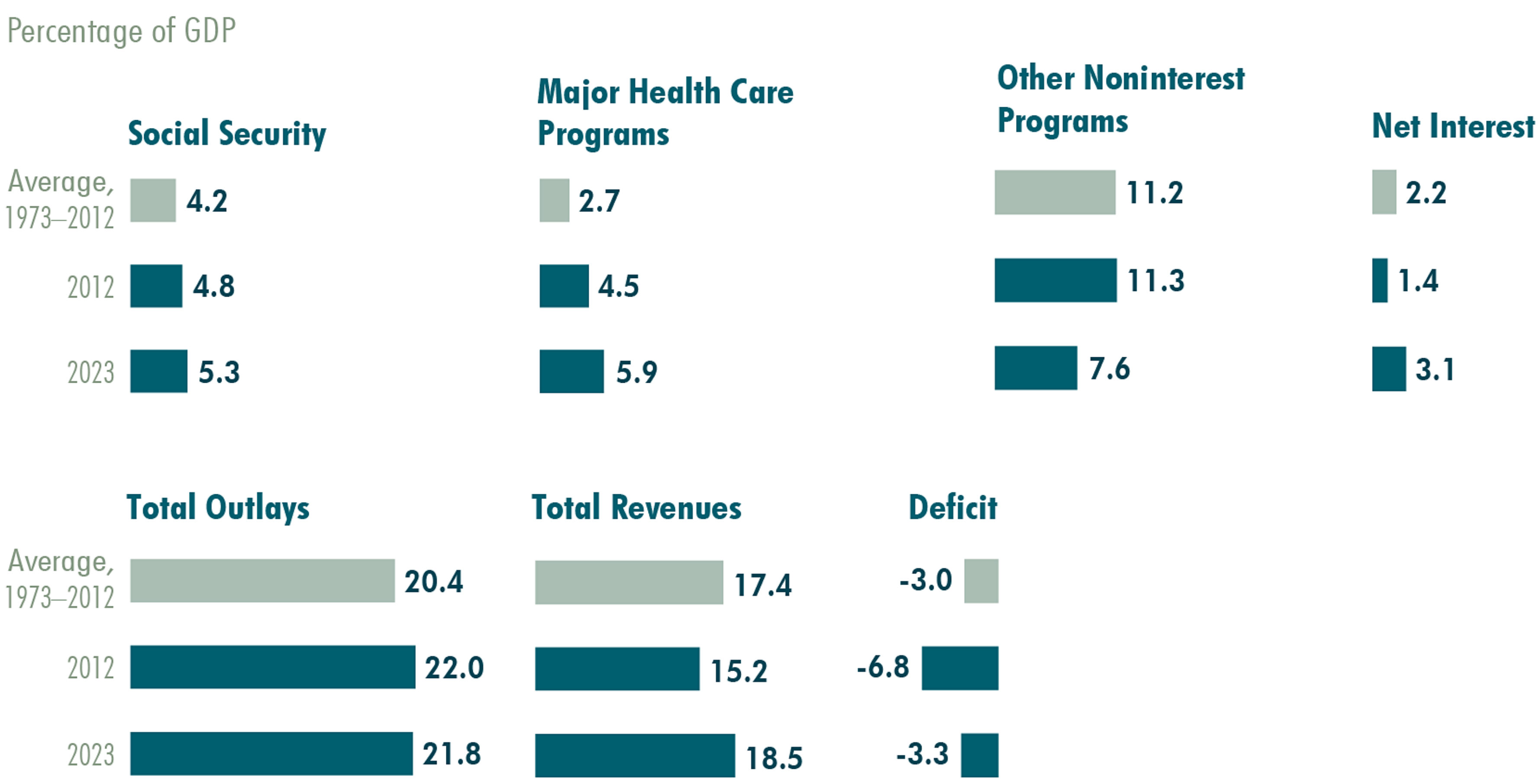
To achieve that goal with policy changes that phased in over time would require changes that save nearly $2 trillion over the coming decade.

What Policies to Use to Reduce Deficits

Context for Policy Choices:

Historical *and* projected growth of federal spending relative to the size of the economy can be attributed almost entirely to growth in spending for a few large programs—namely, Social Security and the major health care programs.

Projected Spending and Revenues Under CBO's Baseline Compared with Historical Experience

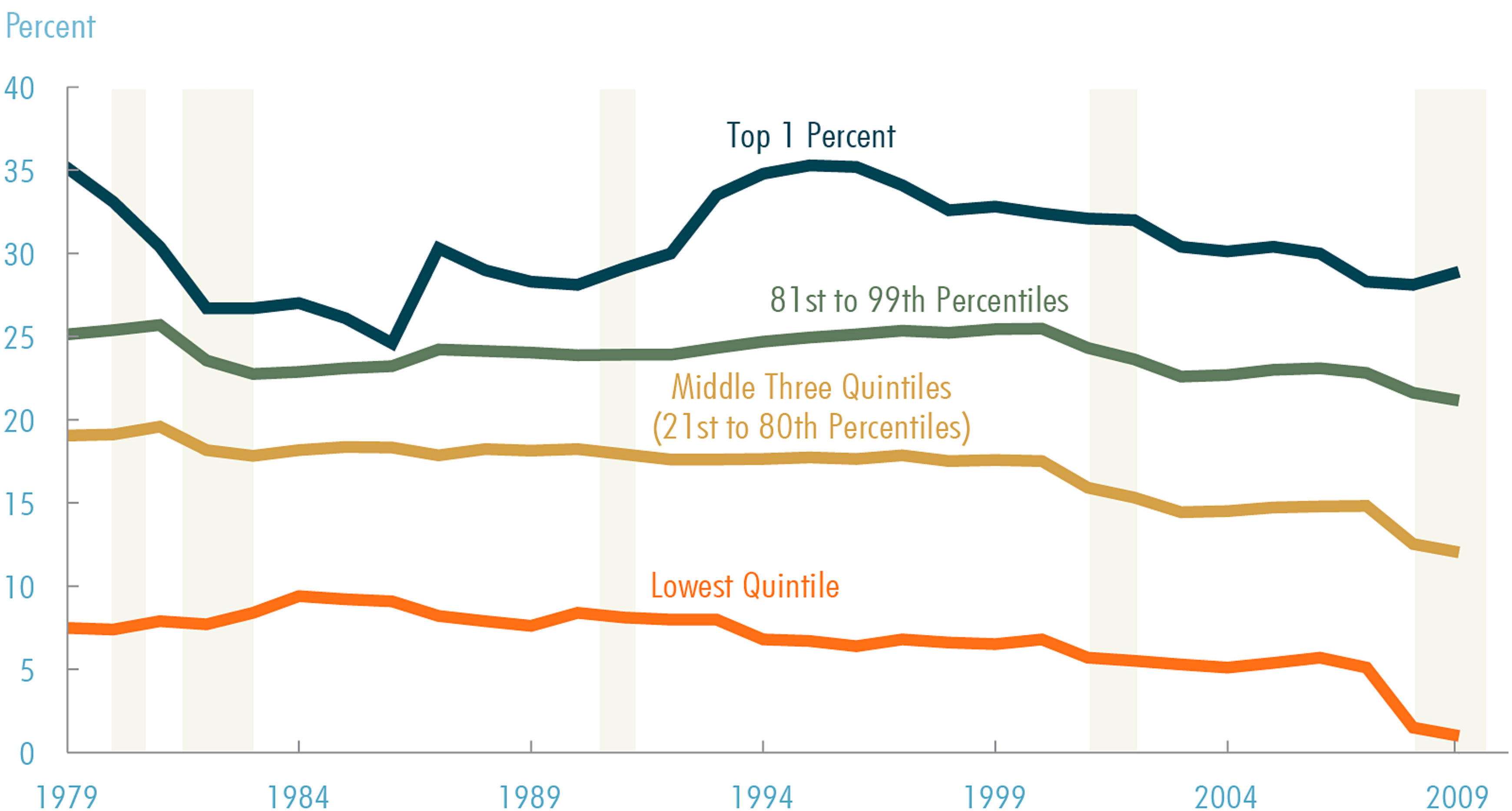


Funding for Discretionary Programs

Changes in Discretionary Funding Between 2007 and 2013:

Total	7 percent
Excluding funding for overseas military operations and in response to hurricanes	12 percent
Excluding funding for overseas military operations and in response to hurricanes, adjusted for inflation	-1 percent

Average Federal Tax Rates, by Income Group



What Timing to Use to Reduce Deficits

Waiting to cut federal spending or increase taxes would lead to a greater accumulation of debt and would increase the size of the policy adjustments needed to achieve any chosen debt target.

However, implementing spending cuts or tax increases quickly would weaken the economic expansion and give people little time to plan and adjust to the policy changes.

The negative short-term effects of deficit reduction on output and employment would be especially strong now, because output is so far below its potential (or maximum sustainable) level that the Federal Reserve is keeping short-term interest rates near zero and could not lower them further to offset the impact of changes in fiscal policy.

What Timing to Use to Reduce Deficits (Cont.)

Even if policy changes were not implemented for a few years, however, making decisions about those changes quickly would give people more time to plan and would tend to increase output and employment in the next few years by holding down longer-term interest rates, reducing uncertainty, and enhancing businesses' and consumers' confidence.

Conclusion

The federal budget deficit has fallen faster than we expected. However, relative to the size of the economy, debt remains historically high and is on an upward trajectory in the second half of the coming decade.

The fundamental federal budgetary challenge has hardly been addressed: The largest federal programs are becoming much more expensive because of the retirement of the baby boomers and the rising costs of health care, so we need to cut back on those programs or increase tax revenue to pay for them.