Today's Deficit is not the Problem

By: David Wessel

There are reasons to be relaxed about the federal deficit. But...

When the books closed on fiscal year 2014 on Sept. 30, revenues were up 9% and spending was up just 1%. Even Medicare grew slowly. The deficit, the gap between income and outlays, was 2.8% measured against the gross domestic product, far from the near 10% peak hit during the Great Recession and below the 40-year average.

Congressional Budget Office projections, not much different than private-sector forecasts, put the deficit below 3% of GDP through 2018 and then rising gradually after that. The debt (the accumulation of all past deficits) is very high by historical standards, but projected to be stable for the near-term as a share of GDP as long as the economy keeps growing. In other words, there is no immediate deficit crisis. If all you care about is the near-term deficit, a do-nothing Congress isn't a big problem.

But...

Those relatively comforting projections assume that Congress will stick to the tough ceilings on annually appropriated spending through 2021 that were written into the Budget Control Act of 2011. The caps are complicated, but to meet them, Congress will have to pass defense and nondefense appropriation bills that ratchet down this spending each year, adjusted for inflation. Measured as a share of GDP, these caps would cause this spending to drop from 6.8% in 2014 to 5.5% in 2021, according to CBO. Over the past 40 years, they've averaged 8.3% of GDP.

That raises three questions: What happens if the caps hold? What happens if they don't? And which outcome is the most likely?

If the caps hold

If they do, then Social Security, health care and interest will claim a bigger and bigger slice of the federal budget and everything else a smaller one.

Nearly everything that counts as an investment in the future – education, infrastructure, R&D – will be squeezed.
CBO estimates that, assuming the caps hold, 85% of the projected increase in annual spending over the coming decade will go to Social Security, major health programs (Medicare, Medicaid, Obamacare) and interest. As a share of GDP, nondefense federal investment spending (which counts for about 9 cents of every $1 of federal spending today) would fall to the lowest level in at least since the 1960s. Increasingly the federal government will resemble a giant health insurance and pension company with a big interest tab with some aging fighter jets.

“Many observers worry that we have not explicitly decided as a society to make those changes. Rather, we seem to be drifting into the changes,” CBO Director Douglas Elmendorf has said. How come? Government benefit programs are on autopilot and annually appropriated spending requires annual votes by Congress.

Although Congress and President Barack Obama agreed to the ceilings on spending, they put off the hard choices of what to cut and what to increase. To give you an idea of how strict the caps are, CBO says that if all the money-saving changes to the Pentagon came through cutting the size of the military (as opposed to reducing wages or benefits or something), the military would have to be cut more than 20%.

If the caps don’t hold

With all that’s going on in the world – the security threats at home and abroad and the angst about the slow pace of economic growth – Congress may decide that those caps sounded good in 2011, but prove too tight to live with by 2018 or so. That'll mean bigger deficits than CBO’s baseline projections.

How much bigger? If annually appropriated spending were allowed to increase just enough to keep up with inflation, then the deficit in 2021 would be about 12% larger (about $100 billion) than the baseline projections. If spending grew at the same pace as the economy, the deficit in 2021 would be about 39% larger ($320 billion) bigger. Unless those spending bills were accompanied by tax increases or cuts in benefit programs, that’d put the deficit closer to 5% of GDP in that year than the 3.5% in CBO's baseline.

In short, the caps make the deficit projections look better, but didn’t solve the choices that Congress and the president have to make about spending, taxes and the federal debt. They merely deferred them.

What’s likely to happen

It depends, of course, on who wins the 2014 congressional and the 2016 presidential elections and on what happens to the economy and on whether the recent slow growth of spending on health care persists, which would give Congress a little more maneuvering room.
My guess, and it is just that, is that the caps will not hold. Either they will be lifted or a lot of money will be spent through “war and emergency” escape hatches. With Ukraine, the Middle East, China and terrorist threats so evident, Congress won’t be comfortable with the defense budget that the caps allow. And, for all their rhetoric, most Republicans and Democrats won’t accept domestic appropriations bills low enough to live within the caps.

Today’s deficit is not the problem. Period. Tomorrow’s looks bigger than the comforting projections suggest.

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