The economy has been operating at full employment for the past several quarters, but is still generating large deficits. This suggests that the need for spending adjustments.

Policy decisions that would reduce federal deficits have been difficult in recent years because of conflicting national priorities. Consequently, some budget analysts have suggested that a freeze on spending accompanied by continued growth in revenues would minimize these differences and would still allow the budget to move toward a surplus by 1991. Additional deficit-reduction legislation will be necessary if deficits are to be gradually reduced to meet annual deficit targets.

4. Congress can suspend the automatic spending cut mechanism of real GDP if the economy either declines or enters a recession.


6. During an economic cycle, as defined by the National Bureau of Economic Research, each quarter is classified into one of four phases. Constant growth rate lines are used to connect the averages of real GDP during the middle-expansion phase and thus give the path of middle-expansion trend GDP. See de Leuven and Hulitnay, ibid., pp. 28-20.


8. Congress can suspend the automatic spending cut mechanism if real GDP is negative for two consecutive quarters or if the OMB and the CBO project growth of real GDP of less than one percent for two consecutive quarters.

9. The CBO's less optimistic scenario projects a projected decrease of deficits from $111 billion in FY 1986 to $52 billion in FY 1989 and slightly exceeds the initial GRH deficit targets.

The amendments to the original GRH Act allow for suspension of the automatic spending reductions if the economy either declines or is expected to perform poorly. The GRH Act is a step in the right direction by focusing attention on the structural component of the deficit. The Act also permits flexibility for changing economic conditions and allows the executive branch—the OMB in particular—for determining the need for spending adjustments.

Conclusion

The economy has been operating at high employment for the past several quarters, but is still generating large deficits. This suggests that the core of the current deficit problem is not cyclical and that further deficit reduction is unlikely without additional fiscal action.

Rapid economic growth from 1983 to 1985 was associated with rising, instead of declining, deficits. Once, special factors accounted for some of the deficit improvement in FY 1987. Policy decisions to allow the growth of outlays and spread the growth of revenues, however, also provided improvement. The experience of FY 1987 illustrates the need for further policy action if structural deficits are to be reduced. Despite the two-year deficit reduction plan, projections for the five-year outlook still show high deficits.

Policy decisions that would reduce federal deficits have been difficult in recent years because of conflicting national priorities. Consequently, some budget analysts have suggested that a freeze on spending accompanied by continued growth in revenues would minimize these differences and would still allow the budget to move toward a surplus by 1991. Additional deficit-reduction legislation will be necessary if deficits are to be gradually reduced to meet annual deficit targets.

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The views stated herein are those of the authors and are necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

Federal Budget Deficits: Sources and Forecasts

by John J. Erceg and Theodore G. Bernard

Federal budget deficits have been large and persistent over the past several years, rising to a postwar high of $211 billion in fiscal year (FY) 1986 before declining a record $71 billion in FY 1987. The Congressional Budget Office (CBO) and the administration's Office of Management and Budget (OMB) project a declining trend of deficits over the next five years (Table 1).

The OMB's more optimistic economic assumptions and policy proposals foresee a steadily declining federal deficit trend between fiscal years 1988 and 1993. Nevertheless, in two of the next three years, projected deficits slightly exceed the recently upward-revised deficit targets initially established under the Gramm-Rudman-Hollings Act (GRH) between 1991 and 1993, they exceed the initial GRH targets by about $20 billion annually. By 1995, if the year now targeted for a balanced budget—the federal budget—would still be in a slight deficit, according to CBO projections.

The CBO's less optimistic scenario projects a projected decrease of deficits from $111 billion in FY 1986 to $52 billion in FY 1989 and slightly exceeds the initial GRH deficit targets, reaching $154 billion in 1993.

This Economic Commentary discusses the sources of federal budget deficits, examines the OMB and CBO forecasts, and suggests the need for additional policy actions to achieve a declining trend of deficits into the 1990s. Under either scenario, it is likely that at some point during the next five years, automatic spending cuts will be required under the current GRH Act.

The Cyclically Adjusted Federal Budget

U.S. Department of Commerce estimates suggest that much of the deficits are associated with policy decisions, although the federal budget is highly sensitive to changes in economic activity. To distinguish between these deficit sources, analysts divide the deficit into cyclical and structural components. The cyclical component of the budget measures the response of outlays and revenues to changes in economic conditions, while the structural component measures discretionary fiscal policy and other noncyclical components.

We can estimate what federal receipts and outlays would be if the economy were growing at a trend rate of gross national product (GNP), free from cyclical fluctuations. This calculation yields the structural component of the budget. The difference between the actual and structural measures of receipts and outlays is the cyclical component. This disaggregation helps to separate the interaction between the federal budget and economic activity.

Currently, the U.S. Department of Commerce, Bureau of Economic Analysis (BEA) publishes two alternative estimates of the structural budget, also called the cyclically adjusted budget. The high-employment budget measures what the federal budget, on a National Income and Product Account (NIPA) basis, would be if the unemployment rate were 6 percent. The second measure is an estimate of what the NIPA basis federal budget would be if the economy were expanding along a particular trend path—middle-expansion trend GNP in this case.

Cyclically adjusted federal budget deficits, measured either way, increased substantially during the 1980s and account for the bulk of actual deficits in recent years. The federal deficit was reduced in 1987 on both an actual and a cyclically adjusted basis, the actual deficit is now between the two BEA measures of the structural deficit.
Thus, under either adjusted measure, structural deficits account for all, or almost all, of the current federal deficit. Moreover, BEA estimates of the cyclically adjusted budget suggest that both OMB and CBO projected deficits are mostly structural and that a high growth economy alone would not eliminate the deficit.

**Composition of Federal Spending**

Because the cyclical component of the federal deficit is now estimated to be near zero, further reductions in the actual deficit must come from the structural component. The sources of structural deficits have varied over the years as budget priorities and policies have changed. Throughout the 1960s and early 1970s, revenues and outlays tended to grow at a similar pace. Outlays (on a unified budget basis) began to soar during the late 1970s and rose to about 24 percent of GNP by the mid-1980s, while revenue growth slowed (figure 1).

Moreover, the composition of spending has changed dramatically in recent years. Spending for national defense more than doubled between 1980 and 1987 while spending for nondefense programs increased by only 58 percent. Consequently, defense spending rose from 5.0 percent of GNP in 1980 to 6.4 percent in 1987 (figure 2).

As a share of GNP, defense outlays have leveled off and are well below the 9.4 percent share of the early 1960s. Apparently, the defense build up has not been its course. Growth in defense spending is projected to slow sharply through the early 1990s, according to both the CBO, despite little or no growth for some programs, such as family support, veterans’ pensions, guaranteed student loans, and unemployment compensation.

Interest expense has also accounted for trend growth in total spending. Net interest costs are the costs of borrowing to finance the federal deficit, offset by the receipt of interest payments from government trust funds and loans. A combination of recent asset sales, prepayments, and sluggish new lending portholds virtually flat interest income over the next several years. As the total federal debt rises, the government needs to borrow more in order to finance current operations, while also seeking new funds to refinance maturing debt. Although repaying more often occurs at higher interest rates, lower rates during FY 1987 offset much of the cost associated with the growing federal debt and allowed for large one-time savings.

Net interest costs, of course, are highly sensitive to interest rates. Thus, projections of future net interest expenses depend on assumptions about interest rates and the size of deficits. Although economic cycles are closely related and seldom, if ever, move in isolation, some rules of thumb from the CBO offer an insight into how higher interest rates would affect the budget. These rules indicate that a one-percentage-point increase in interest rates from the beginning of FY 1988 to the end of FY 1993—for all maturities of debt issued—would cause outlays in 1993 to increase by $5 billion and by 1995 to increase by $10 billion.

High federal deficits and the federal debt explosion in recent years have boosted net interest costs to nearly 14 percent of total outlays and slightly more than 3 percent of GNP, well above recent historical experience. Neither the CBO nor the OMB expects relief over the next several years. Thus, even if the current status of the cyclically adjusted budget allowed for further deficit reduction from economic expansion, the growing burdens of net interest costs would continue. Moreover, about $54 billion has already been cut from previously projected defense spending between FY 1988 and FY 1990. Future deficit reductions will therefore require hard choices among nondefense, interest spending components of the budget, unless taxes are increased.

**Recent Policy Actions**


A significant change in the budget outlook occurred in FY 1987, when the defiicit fell to 71 billion from FY 1986. The FY 1987 deficit reduction resulted from three major factors: 1) special one-time gains, 2) favorable economic conditions, and 3) discretionary policy changes. Approximately half of the $71 billion reduction was the result of one-time factors. The initial effects of the Tax Reform Act of 1986 boosted receipts by an estimated $22 billion more than would have been expected without tax law changes. Capital gains payments, which in late 1986 as investors apparently took advantage of the special long-term capital gains treatment under the old tax law. On the other hand, CBO estimates project that tax law changes, due to the implementation of the remaining individual tax rate reductions, will increase receipts by approximately $10 billion in FY 1988.

Other one-time gains arose from federal asset sales (including loan prepayments, direct loan sales, and the Conrail sale), which added about $8 billion, and the shifting of certain outlays into FY 1988, which saved about $5 billion. This unexpected deficit reduction is not likely to be sustained without further policy actions.

A second source of improvement was cyclical in nature. Generally lower interest rates and an improvement in the agricultural economy led to lower outlays. In addition, stronger employment and income growth in 1987 helped to increase receipts. Tax cuts and gains from economic factors helped to reduce the cyclical component of the budget deficit, which was small relative to the structural component.

Discretionary policy changes, which affect the structural component of the deficit, also accounted for some of the deficit reduction. Spending cuts in defense programs and in several non-defense discretionary programs, such as education, transportation, housing, and fiscal assistance to state and local governments, represented policy actions to cut the federal deficit.

Against a prospect for large deficits that exceed the GRH annual targets, Congress and the administration have agreed to legislation to cut the FY 1988 deficit by $30 billion and to reduce the projected FY 1989 deficit by $6 billion. Economic and technical infeasibility is not a serious issue presented in the administration’s mid-session budget report in August, will indicate if further legislative action is necessary.