Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

Revised June 5, 2006

A "MERE" $300 BILLION
Should a $300 billion deficit be considered a victory?

by Richard Kogan and Aviva Aron-Dine

On May 4, the Congressional Budget Office revised its estimate of the deficit for the current fiscal year (2006) to "significantly less than $350 billion, perhaps as low as $300 billion, assuming enactment of the pending supplemental appropriations and tax reconciliation legislation."[1] On May 9, Goldman Sachs reduced its comparable estimate to $300 billion. Previous similar estimates by these organizations had been around $375 billion.

How should we view a $300 billion deficit? To what extent should we rejoice? We see six points.

- **Rising inequality contributes to revenue growth.** To the extent that they reflect growing income inequality, extra revenues are good news for the budget but not good news for society. CBO explains the greater-than-forecast growth in revenues in part by saying, "growth in incomes in 2005 may have been concentrated more than expected among higher-income taxpayers, who face the highest tax rates."

- **At 2.3 percent of GDP, a $300 billion deficit is well above historical norms.** The Adminsitration may claim that a deficit of 2.3 is low by historical standards, implying that the deficit constitutes no problem or cause for complaint. This is not so. Over the course of U.S. history, deficits averaged 1.2 percent of GDP, and that average includes the large deficits during the Civil War, the First and Second World Wars, and the Great Depression.[2] Excluding those three wars and

KEY FINDINGS

- **Some of the revenue increase appears to have been caused by growing income inequality rather than general economic improvement.**
- **The current deficit — and the resulting increase in debt — are substantially worse than the historical norm, especially for a period of economic recovery.**
- **Running a $300 billion deficit burdens future taxpayers; it causes the debt to grow faster than the economy, which is not sustainable on an ongoing basis.**
- **At this stage in the business cycle — 4½ years after the bottom of the 2001 recession — the deficit should be much lower than $300 billion. Lower deficits are necessary to increase national saving — which is at historic lows — in order to better prepare the nation for the coming retirement of the baby-boom generation.**
- **As Goldman Sachs has said, the current surge in revenues likely is due in part to temporary factors, and the rate of revenue growth is expected to slow in coming years.**

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[1] CBO, *Monthly Budget Review*, May 4, 2006, at http://www.cbo.gov/ftpdocs/71xx/doc7184/05-2006-MBR.pdf.

[2] Historical data were prepared by GAO from a number of sources, and extend back to 1797.

the Great Depression, deficits averaged only 0.3 percent of GDP. During the Clinton Administration, they averaged only 0.1 percent of GDP.

The Deficit In Historical Context
The deficit as a percentage of GDP during specified time periods

2006		2.3%
2002-2006	Bush	2.7%
1994-2001	Clinton	0.1%
1982-1993	Reagan/Bush	4.3%
1797-2006	Washington-Bush	1.2%
1797-2006	Excluding 3 wars & Great Depression	0.3%

True, a deficit of 2.3 percent of GDP is less than the 4.3 percent averaged during the 12 years of the Reagan/Bush Administrations. But that 12-year period was the *only period in the history of the United States* in which the government consistently ran large deficits — i.e., increased the debt-to-GDP ratio — during a time of peace and prosperity. (Note that the cost of the wars in Iraq and Afghanistan, at about $100 billion per year, amounts to less than 0.8 percent of GDP per year and so account for only a fraction of the 2006 deficit.)

- **A $300 billion deficit increases the burden on future generations.** A $300 billion deficit will cause the debt to grow faster than the economy; it will cause the debt-to-GDP ratio to rise this year.[3] When debt rises faster than the economy, it becomes a growing burden — future taxpayers will have to devote more of their taxes to paying off debt, or alternatively to paying interest on the debt. Put simply, a rising debt-to-GDP ratio means that the nation is increasing the financial burden on future generations, while a falling debt-to-GDP ratio means that the nation is reducing the burden on future generations. The debt cannot grow faster than the economy forever without eventually causing bankruptcy.

  In each of the first five years of the current Administration, the debt-to-GDP ratio increased. This is not typical, especially not during an economic recovery. In each of the eight years of the Clinton Administration, the debt-to-GDP ratio fell. And while the debt-to-GDP ratio rose in 11 of the 12 years of the Reagan and first Bush Administrations, it fell in 26 of the 35 years from the end of World War II to the start of the Reagan Administration.

Is Debt Rising Or Falling?
Increase or decrease in debt held by the public as a percentage of GDP during specified time periods

2001 - 2006	Bush	+4.4%
1993 - 2001	Clinton	-16.4%
1981 - 1993	Reagan/Bush	+23.6%
1947 - 1981[a]	from Truman through Carter	-70.4%

[a] This comparison uses 1947 as the base year. During that year, the budget was in surplus and the debt had already fallen as a share of GDP from its high point. To that extent, our figure understates the amount by which debt/GDP fell during the Truman Administration.

- **At this stage of the business cycle, the deficit should be much lower.** The bottom of the most recent recession is now 4½ years behind us. Given the impending retirement of the "baby boom" generation and the pressure that will place on costs for Medicare, Medicaid, and Social Security, the government should be running small deficits or even surpluses (thereby reducing the debt-to-GDP ratio) during the years of this decade when the economic recovery is mature. The goal should be to pay off a significant chunk of the debt before the baby boomers

[3] For this purpose, we are examining debt held by the public, the measure of debt that economists use to gauge the economic effects of the budget. Debt held by U.S. government trust funds such as the Social Security trust fund also is rising faster than the economy, but in this case, the extra burden on the Treasury is matched by extra assets in the trust funds, and the two effects cancel each other out for the government and economy as a whole.

Revenue Growth in Current Recovery Remains Weak Overall

If 2006 revenue levels turn out to be significantly higher than were projected in March of this year (as CBO's May Monthly Budget Review implies may occur), 2006 will be the second year in a row of strong revenue growth. Some may seek to portray these two years of growth as evidence of a particularly robust economic recovery, evidence that recent tax cuts are "paying for themselves," or evidence that low revenues are not responsible for the nation's high deficits.

When other considerations are taken into account, however, recent revenue growth no longer seems evidence of either the tax cuts' success or restored revenue adequacy. In addition to the points noted elsewhere in this analysis (that recent revenue growth may stem in part from increased income inequality and is linked to the ebb and flow of the business cycle), it is important to remember that overall revenue growth in the current recovery remains quite weak. Even if revenue levels in 2006 are significantly higher than anticipated, *revenue growth in this recovery still will be well below the average for all other equivalent post-World War II recovery periods and much weaker than revenue growth in the equivalent period of the 1990s recovery.*

Revenue growth in 2005 and 2006 follows several years of very weak growth or actual *declines* in revenues, including three straight years (2001-2003) in which revenue levels dropped in nominal dollars, an almost unprecedented occurrence since World War II. That revenue growth in the recovery as a whole remains weak by historical standards strongly suggests that the recent robust revenue growth is a belated and still incomplete return to historical norms, not a reason for complacency regarding the fact that revenues continue to lag well behind expenditures.

retire, as President Bush promised to do in his first budget.

- **Given the national saving rate, the deficit should be much lower.** The goal of paying off debt is especially important because the national saving rate, which is the net of deficits and surpluses run by individuals, corporations, and governments, is at unusually low levels. Over the next decade or two, increasing the national saving rate is the single most important policy the nation can undertake to prepare for the coming retirement of the baby boomers. By far the most effective way to increase the national saving rate is to run smaller deficits, or even run surpluses, when the economy is growing at a reasonable rate.

- **Revenue growth will likely slow.** There are good reasons to believe that the rate of revenue growth will slow when the current phase of the business cycle ends and quite possibly sooner. Goldman Sachs, which expects slowing, explains, "the fact that the bulk of the surprises have occurred in nonwithheld personal taxes and in corporate taxes continues to suggest that the strength is largely transitory. … by far the largest component [of the unexpected growth in personal tax receipts] reflect[s] one-off events such as better than expected year-end bonuses, capital gains realizations, and the like. … While the strength in corporate taxes appears more genuinely rooted in profit growth, this is more vulnerable in a mature expansion. … [P]rospects for further strong growth in profits appear constrained."[4]

[4] Ed McKelvey, GS US Daily Comment, May 9, 2006.