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The Fiscal Cliff in Context

Fernando M. Martin, *Senior Economist*

According to the latest estimates by the Congressional Budget Office (CBO), unless government policymakers revise current law, the federal deficit is expected to decrease from 7.0 percent of gross domestic product (GDP) in 2012, to 4.0 percent in 2013, 2.4 percent in 2014, and 1.2 percent in 2015.[1] This sharp fiscal contraction, dubbed the fiscal cliff in the news, mainly involves the expiration of various tax cuts and credits, unemployment insurance extensions, and Social Security payroll tax relief; the decrease in Medicare payment rates; and automatic spending cuts as specified by the Budget Control Act of 2011 (also known as "sequestration").

Naturally, the size and abruptness of the projected deficit reduction under current law have raised concerns of lower output and higher unemployment, prompting anticipation of an alternative deal between the political parties on how to address the current fiscal situation. One possibility is overturning most of the previously mentioned deficit-cutting measures and continuing to push forward the fiscal issue unresolved. In addition to the political considerations, the historically low interest rates on Treasury securities greatly mitigate any sense of urgency to resolve the deficit problem and curb the debt increase.

The decision of which fiscal path to take involves difficult choices, so it is useful to put the current debate in context. Specifically, where are we relative to the past, how did we get here, and where are we going?

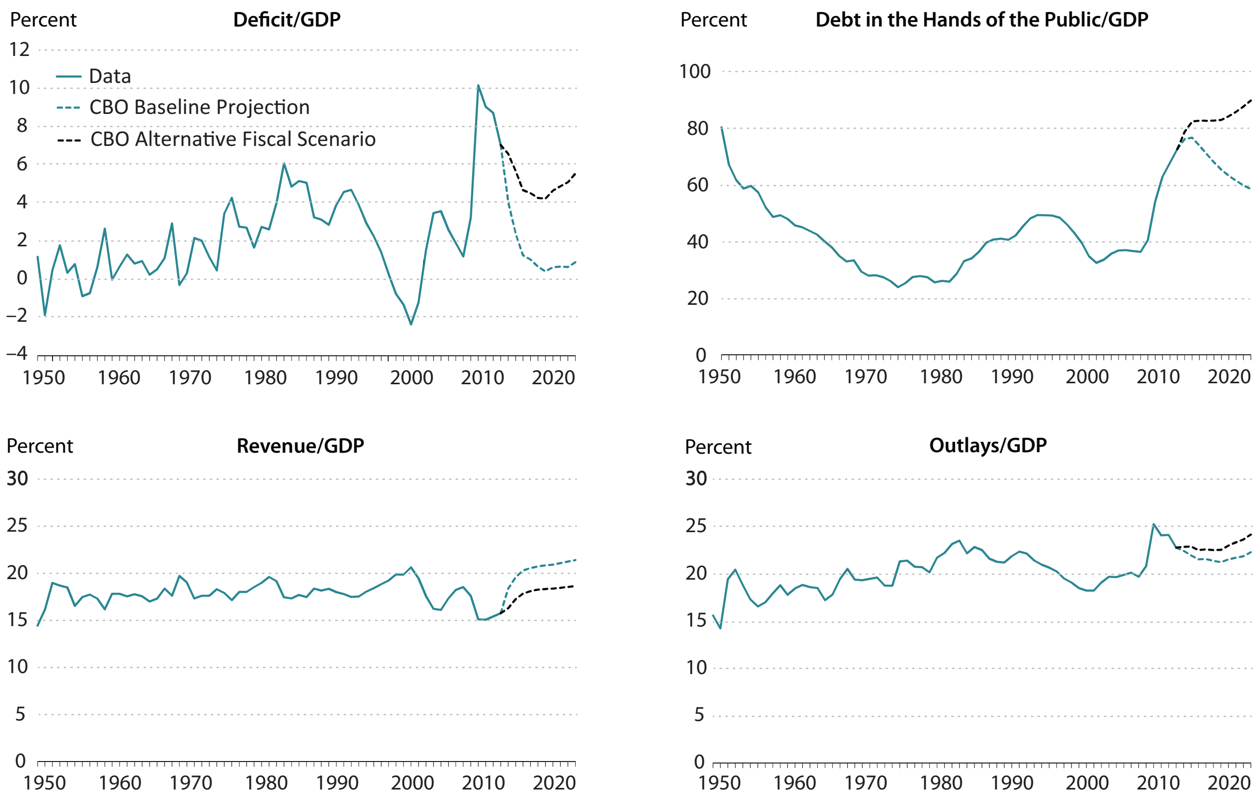
The chart shows the federal deficit, debt, revenue, and outlays, all in terms of GDP, since 1950 and projected until 2022. The CBO has produced two sets of estimates for the 2013-22 period: The baseline scenario assumes current law remains in effect. The alternative scenario maintains most current policies, basically extending almost all expiring tax provisions indefinitely and avoiding spending cuts. As the chart shows, the deficit for the past four fiscal years has been larger than at any other time since World War II. Furthermore, the difference between the two fiscal scenarios is striking: The baseline scenario estimates an average deficit of 1.2 percent of GDP over the next 10 years; this figure climbs to 5.0 percent under the alternative scenario. As a reference point, the deficit averaged 1.8 percent of GDP between 1950 and 2008.

Federal revenue is currently well below its postwar, pre-crisis average, while expenditure is well above, with both factors contributing to a large and persistent deficit. Under current law, the deficit situation would be quickly, if painfully, resolved, with the lion's share resulting from increased tax revenue.

From 1950 to 2008, federal revenue averaged 18.0 percent of GDP. Revenue fell substantially below the historical average in recent years, mostly because of a series of tax provisions (in 2001, 2003, 2009, and 2011-12). For example, in 2012 revenue as a percent of GDP was only 15.8 percent. Before 2009, only 1950 had a lower figure. Back then, unlike now, the budget was roughly balanced. If current law is not overturned, revenue as a percent of GDP is expected to rise drastically over the next few years—to 18.4 percent in 2013, 19.6 percent in 2014, and 20.3 percent in 2015—and surpass its historical maximum by 2019. In contrast, the alternative scenario, which would extend most tax provisions, would eventually return revenue to its postwar average. The difference in revenue between the two scenarios accounts for about two-thirds of the difference in the projected deficit over the next 10 years.

Total federal outlays averaged 19.8 percent of GDP between 1950 and 2008. If interest payments on the debt are subtracted, outlays drop to 17.8 percent of GDP. Given the revenue figures above, then, we can see that the federal government has, on average, run a postwar policy of a zero primary deficit. The government deviated drastically from this policy with its response to the recent financial crisis

Federal Deficit, Debt, Revenue, and Outlays as a Percent of GDP



SOURCE: Congressional Budget Office and author's calculations.

and subsequent recession; total outlays averaged 24.0 percent of GDP between 2009 and 2012.

The alternative CBO scenario, which avoids any spending cuts (although some caps on discretionary spending are maintained), estimates outlays averaging 23.0 percent of GDP over the next 10 years. Even if no new deal is brokered and sequestration is implemented, the CBO estimates expenditure will remain high by historical standards. The baseline scenario estimates outlays averaging 21.7 percent of GDP over the same period. Notably, under this scenario, expenditure is not expected to decrease in nominal (i.e., dollar) terms from its 2012 level, although it would remain fairly flat for the next two years.

In summary, federal revenue is currently well below its postwar, pre-crisis average, while expenditure is well above, with both factors contributing to a large and persistent deficit. Under current law, the deficit situation would be quickly, if painfully, resolved, with the lion's share resulting from increased tax revenue. If a deal is struck that reverses most of the deficit-cutting measures, then expenditure and the deficit will remain elevated for the next 10 years. In this alternative scenario, debt held by the public would reach 90 percent of GDP by 2022 instead of a more manageable 60 percent under the baseline scenario. In addition, the uncertainty about how a persistently larger government will be financed is likely to have a negative impact on the private sector's outlook, thus further delaying the economic recovery. This effect needs to be weighed against the immediate costs of reducing the deficit when evaluating competing alternatives for the future fiscal path of the United States. ■

Note

[1] The deficit is defined as the difference between outlays and revenue. Outlays include all forms of government spending (i.e., purchases of goods and services, transfers to individuals and other grants, and interest payments on the debt). The primary deficit excludes interest on the debt. All years referred to in this essay are fiscal years. The fiscal year in the United States begins on October 1 and ends on September 30 of the subsequent year and is designated by the year in which it ends. Before 1977, the fiscal year began on July 1 and ended on June 30.

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