The federal deficit is on the road to improvement

On Tuesday, the Congressional Budget Office (CBO) released its new budgetary and economic forecasts. This non-partisan body of the Congress thereby gives us a base scenario, which provides a better understanding of trends in federal public finances. In the weeks to come, the White House and both chambers of Congress should also be issuing their own budget proposals. It is far from assured, however, that these proposals will eventually become law.

For the first time, the CBO’s new estimates include the consequences of the agreement on the fiscal cliff that was reached on January 1. Since the organization must take the existing laws into account, it presumes that the automatic spending cuts that were postponed from January 1 to March 1 will take place. It therefore estimates that the federal deficit will drop from US$1,089B in 2012 to US$845B in 2013, the first fiscal year since 2008 that the shortfall has stood below a trillion dollars. The forecast economic growth (annual change in real GDP in the fourth quarter) will probably remain slow according to the CBO, slipping from 1.5% in 2012 to 1.4% in 2013. It is estimated that the partial fiscal cliff will subtract 1.5% from economic growth this year. After that, things will improve significantly: the deficit will bottom out at US$430B in 2015. The budget situation will be boosted by stronger economic growth: the CBO is calling for a 3.4% increase in real GDP in 2014 and average growth of 3.6% between 2015 and 2018.

These economic outlooks may appear pessimistic for this year and overly optimistic for the ensuing periods. Yesterday, President Obama opened the door to a new, short-term agreement to avoid the full effect of automatic spending cuts, and we may assume that the US$51B cut in the current fiscal year will be reduced. It is also plausible that the CBO is attaching too much importance to the macroeconomic effect of the 2% rise in the payroll tax (in 2011, the tax cut had virtually no positive effect on growth). Therefore, the annual change in real GDP in the last quarter of 2014 should be closer to 2.5%. Furthermore, the deficit could shrink less if the automatic spending cuts do not all take place.

In the medium term, economic growth firmly anchored at around 3.5% would obviously be desirable, but the reality is likely to be less rosy. Even the CBO estimates that potential GDP growth will be 2.2%. Thus, there is quite a gap. Our base scenario is calling for growth of around 3.0%.

It is interesting to note that the CBO believes that the U.S. deficits will start widening again from 2016 onwards, boosted to begin with by the increase in net interest payments, and then by greater social spending (healthcare and old age security). Therefore, not only is it necessary to keep repairing public finances in the short term, and without weakening economic growth too much, but a lasting solution must also be found to resolve the long-term problem caused by the inevitable aging of the population.

Implications: The U.S. federal government’s budget situation should improve considerably in the years ahead, even if the economic forecasts are rather optimistic beyond 2013. However, some pitfalls still lie ahead for public finances in the longer term.