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Economic Watch

United States

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Economic Analysis

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Improved Short-Term Budget Outlook

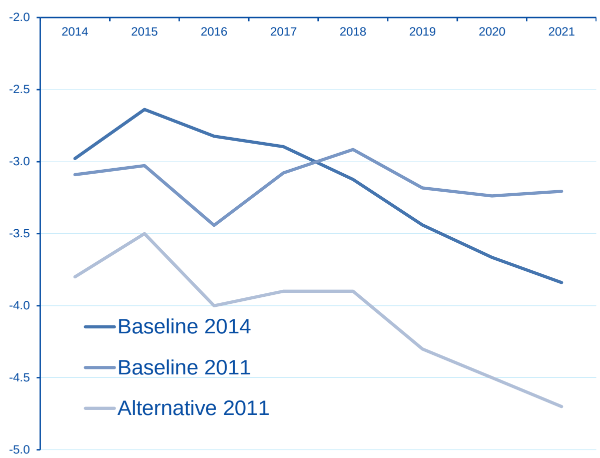
Long-term uncertainty remains

- 2014's budget deficit will be lowest since 2007
- If current trends continue, the debt-to-GDP ratio will climb to 79.2% by 2024, the highest since 1948
- It is imperative that there are enough incentives for policymakers to take action and fix long-term issues

This week, the Congressional Budget Office (CBO) released updated budget projections for fiscal years 2014-2024. For 2014, the deficit is forecasted to total $514 billion, which is close to the historical average of 3.0% of GDP, but nevertheless the lowest levels since 2007. Revenues are projected to reach $3.0 trillion, an increase of 44% from 2009. This is due to higher individual income proceeds, which have benefited from the six million net-jobs created since 2010, as well as because of restoration of tax rates after certain tax-cuts set in place by prior legislation expired. These revenues explain more than 55% of the total increase between 2010 and 2014. Corporate income and social security contributions combined account for almost 40% of the increase.

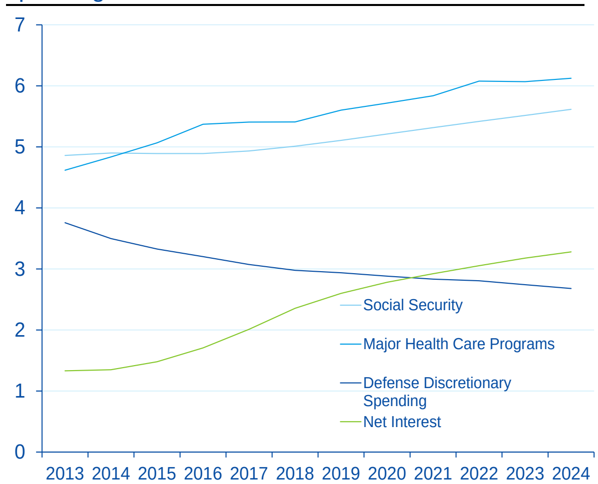
On the outlays side, spending is expected to increase in 2014 by 2.6% to $3.5 trillion, which is around 30% higher than pre-recession levels but almost 2% lower than their historical peak in 2011, when the government implemented a massive fiscal stimulus program. The moderate increase reflects the impact of lower discretionary outlays that partially offset ongoing pressures in non-discretionary spending. In fact, discretionary spending will drop to their lowest level in seven years, as a result of the 2011-2013 budget negotiations, including the 2011 Budget Control Act that triggered automatic sequestration. In addition, net interest spending is expected to show a modest jump due to the low interest rate environment.

Chart 1
Budget Balance as % of GDP



Source: CBO & BBVA Research

Chart 1
Spending as % of GDP

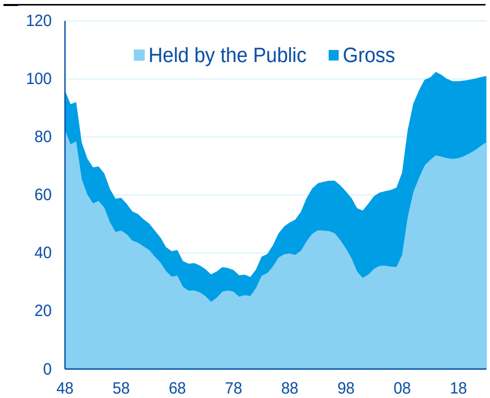


Source: CBO & BBVA Research

Chart 1 illustrates the projections for the annual deficit as a percentage of GDP. The forecasted deficit as a percentage of GDP for baseline scenarios has improved significantly over the last three years in comparison to alternative scenarios. In fact, the baseline scenarios for 2011 to 2014 are relatively unchanged. When comparing the current forecasted deficit with the 2011 alternative scenario where tax cuts would have been extended, however, we see that the budget deficit could be much worse than it is today. Despite the political turmoil and backlash in Washington, Congress was able to curb the deficit to an extent and some necessary steps have been taken to move forward in the right direction. However, this does not mean that mid- and long-term fiscal issues have been resolved. That is why it is crucial that policymakers tackle this issue moving forward.

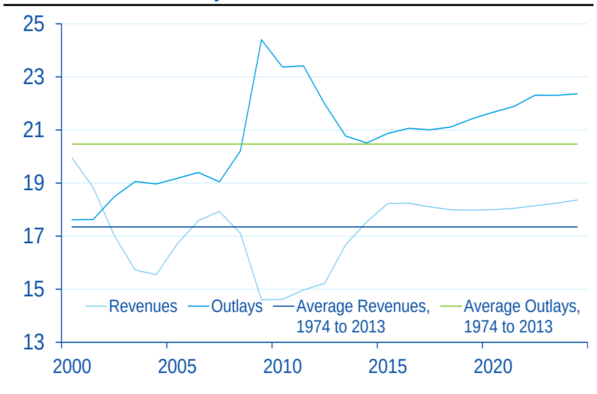
Although 2014's budget deficit as a percentage of GDP will be the smallest in six years, debt held by the public will reach 74% of GDP, the highest ratio since 1950. Through 2017, debt-to-GDP ratio is forecasted to decline to 72.6% before reaching 79.2% in 2024 due to increases in interest payments and entitlement programs that will drive government expenditures upward. In fact, interest payments are expected to make up 1.3% of GDP in 2014, but rise over the decade to 3.3% of GDP by 2024. Moreover, healthcare expenditures are expected to increase by an average of 7% over the next decade, in the absence of effective policy measures to curb these outlays. In addition, gross federal debt surpassed 100% of GDP in 2013, reaching its highest percentage in the post WWII period, and is expected to remain around this level during the next decade. These high debt-to-GDP ratios limit the ability of fiscal policy to respond to potential future negative shocks. In the short run, the outlook continues to look upbeat as the economy finally appears to be consistently expanding at a steady clip. The employment situation is beginning to stabilize, consumer spending continues to steadily increase, financial asset prices have posted strong gains, interest rates remain well below historical averages, and our outlook for housing has improved. In addition, for the first time in several years, it appears that the U.S. will experience healthy GDP growth, while also having an improved fiscal position.

Chart 2
Federal Debt as % of GDP



Source: CBO & BBVA Research

Chart 3
Revenues and Outlays as % of GDP



Source: CBO & BBVA Research

This environment provides policymakers with the opportunity to shift their attention to long-term budgetary challenges. Unfortunately, the lack of bipartisanship and the fact that it is an election year suggest there will not be an agreement on a long-term solution before the mid-term election. Moreover, the positive growth outlook may reduce the incentives of policymakers to compromise. As a result, the probability of a major tax or entitlement reform before 2016 is low.

Other considerations regarding the future of our healthcare system and interest payments remain. As the population ages and baby-boomers slowly begin to retire, federal programs such as Social Security, Medicare, and Medicaid, will begin to demand a higher percentage of the federal budget. Under current conditions, social security spending will increase from 4.9% of GDP today to 5.6% of GDP by 2024, and other major health care programs, such as Medicare and Medicaid, will jump from 4.8% of GDP to 6.1% over the next decade. As a result, the share of total spending to GDP is expected to climb back up again to close to 23%, well above the historical average.

Additionally, the Affordable Care Act's impact on federal spending remains unclear; however, it could be significant if it fails to contain healthcare costs. If investors start to lose confidence in their ability to efficiently manage U.S. entitlement expenditures, borrowing costs would rise and a growing share of government spending would need to be devoted to interest payments. Thus, fiscal mismanagement would inevitably lead to reductions in other areas of the budget or an increase in taxes.

Furthermore, the short-term costs of not agreeing on a long-term solution increase levels of policy uncertainty, which could cause companies to be more cautious when making investments. This could potentially lead to reduced competitiveness, crowding out, lower business activity, higher unemployment, and thus, lower potential GDP growth.

Bottom Line:

As economic growth and job creation gain traction, policymakers should shift their attention to long-term budgetary challenges. Through 2017, we forecast the economy to grow by around 2.6% on average, which should encourage businesses to hire and put downward pressure on the unemployment rate. However, there has not been a far-reaching compromise over U.S. fiscal policy as Washington has chosen to "kick the can down the road" rather than formulate a long-lasting solution. If the elephant in the room continues to be ignored, it will become increasingly difficult to arrive at a feasible solution and it increases the likelihood of sharper spending reductions or tax increases. This in itself could amplify polarization which in turn will make compromise in the future even less likely.