

Huge US budget deficits: Can they be financed without tax hikes?

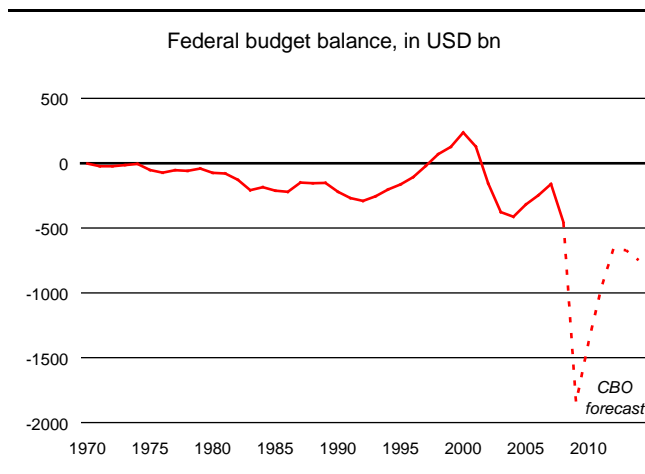
Roger Kubarych

- The Obama administration's budget proposals have passed the House of Representatives and the US Senate but in somewhat different versions. The compromise legislation needed to ratify the budget has bogged down in disputes among the majority Democrats about how to limit future deficits and check the rise in the national debt.
- The budget deficits envisaged are huge: above USD 1.8 trillion in the current fiscal year, 13% of GDP, followed by gradual reductions that would still leave the estimated deficit above USD 650 bn (just over 4% of GDP) by 2012. From then on, deficits would expand indefinitely.
- Past experience suggests that the US government has increasingly depended on foreign private and official purchases of Treasury securities to finance its deficits. But access to foreign funding is not unlimited, and domestic savings are insufficient to take their place.
- Therefore, soon after the recession ends, it is highly likely President Obama will face the unenviable task of proposing new taxes, perhaps even including European-style value-added taxation. This week, the president took the first step toward grappling with that challenge by announcing a Task Force on tax reform to be led by presidential counselor Paul Volcker. The Volcker group has until December to figure out what to recommend.

Budget deficits and the business cycle

Budget deficits go up during recessions. Outlays for unemployment compensation rise, while tax revenues decline as personal income and profits sag. Lower interest rates mean reduced taxable earnings on savings, too. Less well known, however, is that budget deficits typically continue to go up even after a recession ends.

BUDGET DEFICITS WON'T END AFTER THE RECESSION DOES



counter-cyclical measures often begin to have their greatest impact only with a lag, after a recession is over. And corporate profits are slow to rebound, not least because companies are able to use tax-loss carry-overs to reduce taxable income in the first years of a business recovery. Factors such as these will have even more prominent effects because of the sweeping changes in broader economic policies that are incorporated in the Obama administration's budget.

The non-partisan Congressional Budget Office (essentially, Congress' equivalent to the technical experts at the White House Council of Economic Advisers, CEA, and Office of Management and Budget, OMB) has recently "scored" the Obama administration's short and medium-term budget plans. Based on economic assumptions that are a little less optimistic than the administration's projections (and the Fed's, too), the CBO has estimated that the federal government's budget deficit will reach USD 1.8 trillion in fiscal year 2009 and edge back only to a low of USD 658 bn by 2012. After that, rising government spending programs will push the deficit back up for years to come.

CBO: OBAMA BUDGET TO ADD USD 1.6 TRILLION TO DEFICIT

<i>USD bn</i>	revenues	outlays	deficit
2008, actual	2524	2983	-459
2009	2159	4004	-1845
2010	2289	3669	-1379
2011	2586	3556	-970
2012	2917	3575	-658
2013	3095	3767	-672
2014	3231	3979	-749

Source: Congressional Budget office

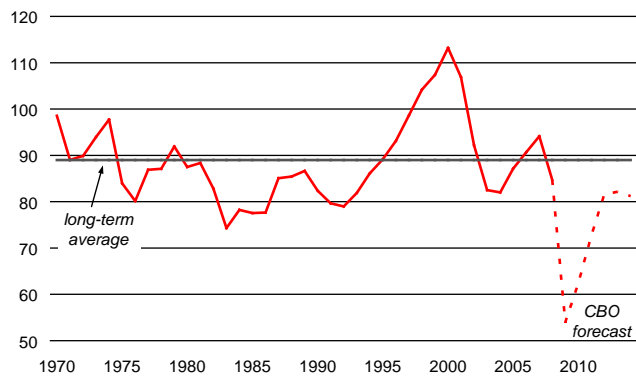
Financing US budget deficits

Federal government outlays can be financed in only two ways – through taxes or through borrowing. Taxes traditionally predominate, but that portion has drastically declined as a result of the policy responses to the financial crisis (cf. chart on the next page).

The US Treasury borrows in two ways: to a small extent by placing securities with other government departments, such as the government employees' pension fund, but mostly by selling its debt to the public. It is the size of the debt held by the public that is of paramount interest to financial market participants. In calendar year 2008, for instance, the Treasury's liabilities soared by USD 1.37 trillion, while debt held by the public climbed USD 1.24 trillion. These numbers swamp anything that has ever occurred before. About half of the increased debt offset a national income and products account deficit of USD 509 bn and sizable fixed investments, mostly in the defense sector. But the new factor of great significance was the net acquisition of financial assets of USD 683 bn associated with the various emergency lending programs to deal with the financial meltdown.

RATIO OF TAXES TO FEDERAL OUTLAYS HAS PLUNGED

Share of outlays financed by revenues, in %



REST OF THE WORLD FINANCES THE US TREASURY

In USD bn (annual averages)

