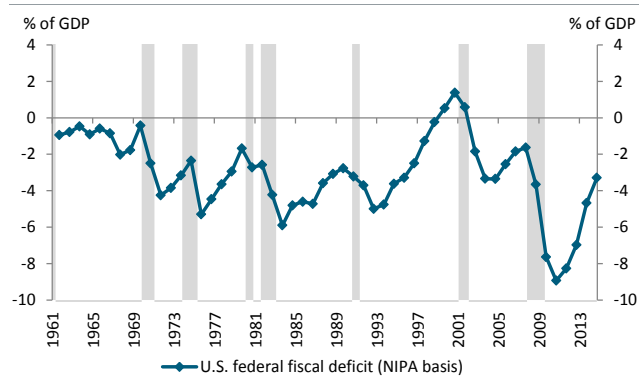


Accounting for Changes in the U.S. Budget Deficit

By Troy Davig and Michael Redmond

The U.S. federal fiscal deficit has improved notably since the end of the Great Recession. We document the source of the improvement by breaking changes in the deficit into three different components: temporary factors, the business cycle, and longer-term structural policies. Most of the improvement in the deficit is due to temporary factors stemming from higher Federal Reserve remittances, dividends from Fannie Mae and Freddie Mac, and the end of stimulus measures enacted to combat the Great Recession.

Chart 1: The U.S. deficit

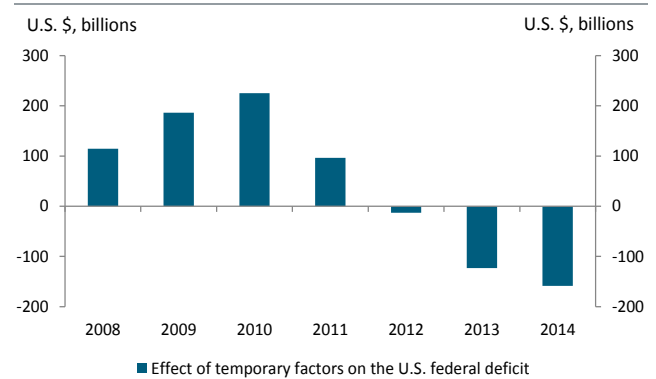


Sources: Bureau of Economic Analysis, NBER.

Chart 1 highlights the improvement in the deficit over the past few years.¹ To understand the driving factors behind this improvement, changes in the deficit can be separated into three components. First, temporary factors include the additional proceeds or expenditures from unique factors that do not necessarily reflect the business cycle or long-lasting legislated policy changes. For example, following the Great Recession, the federal government realized substantially higher proceeds from the Federal Reserve than prior to the crisis, as well as a significant amount of dividends from the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. In addition, various stimulus packages were enacted that temporarily reduced federal government tax receipts and increase federal spending. Chart 2 shows temporary factors raised the federal deficit substantially in 2008-11, had a roughly neutral effect on the deficit in 2012, and then lowered the deficit in 2013-14.²

Following four years of the largest deficits since World War II, the U.S. federal budget deficit fell in 2014 to the point where it was no longer unusually large compared with deficits during the previous three decades. While the cyclical recovery in economic activity played a role in this improvement, about half of the decline in the deficit since 2009 is due to an array of temporary factors, particularly Federal Reserve remittances to the U.S. Treasury, dividend payments from Fannie Mae and Freddie Mac, and the unwinding of one-time policies intended to stimulate economic activity following the Great Recession.

Chart 2: Temporary factors



Sources: Congressional Budget Office, authors' calculations.

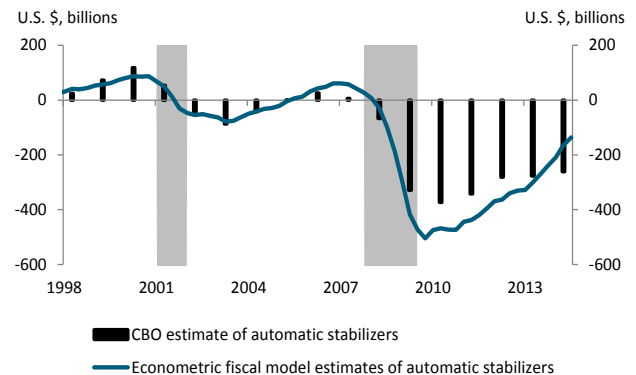
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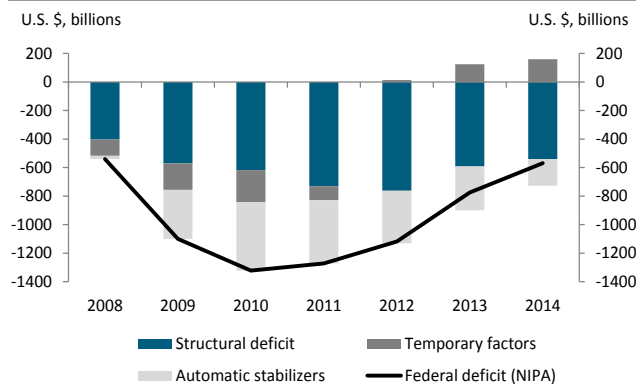
Automatic stabilizers—the second major factor affecting the deficit—reflect movements in revenues and expenses that would have occurred absent any policy reforms. That is, they arise from cyclical fluctuations in the economy, including the interaction between the business cycle and the tax code or social safety net. For example, when recessions occur, declining economic activity reduces the tax base resulting in less government revenue even as spending on social programs rises. Chart 3 highlights two estimates of the automatic stabilizers' contribution to the deficit, one from the Congressional Budget Office and one from a statistical model.³

Chart 3: Automatic stabilizers and the U.S. deficit



Source: Authors' calculations.

Chart 4: Decomposing changes in the U.S. deficit



Sources: Bureau of Economic Analysis, authors' calculations.

The third factor affecting the deficit after contributions from temporary factors and automatic stabilizers are removed is the structural deficit—that is, the deficit that would be realized if the economy were operating at its potential level. Chart 4 shows the overall contributions of each of the three factors over the past several years. Since 2010, the budget deficit as reflected in the national income and product accounts has fallen by about \$750 billion. About half of this improvement (around \$385 billion) reflects temporary factors. Another \$295 billion reflects an improving economy—that is, the automatic stabilizers. Looking ahead, our estimates suggest there is still some scope for improvement in the deficit stemming from cyclical improvement in the economy. However, temporary factors and longer-term structural issues are likely to mitigate further deficit improvement in the years ahead.

¹ All deficit values are reported on a U.S. federal fiscal year basis. The transactions used are recorded in the national income and product accounts produced by the Bureau of Economic Analysis (BEA) rather than the more commonly cited budget scoring provided by the Office of Management and Budget's Budget of the United States Government because the BEA's measure better reflects how federal fiscal policy affects the economy. See "CBO's Projections of Federal Receipts and Expenditures in the National Income and Product Accounts."

² The temporary factors include the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009, excluding the AMT adjustment, as well as the temporary 2-percentage-point payroll tax reduction, Fed remittances above the pre-crisis level, dividends from the GSEs, and emergency unemployment compensation.

³ For more, see Davig and Redmond, "Accounting for Changes in the U.S. Budget Deficit," Federal Reserve Bank of Kansas City, *Economic Review*, forthcoming.

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