"Fiscal Space" and the Federal Budget

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Policymakers are interested in the concept of "fiscal space," or the amount of room available for additional government borrowing, as they discuss plans for the federal budget. Though budget deficits have declined in recent years, debt held by the public was estimated to equal 76.6% of gross domestic product (GDP) at the end of FY2016, which would represent the highest ratio since FY1950. This Insight examines contributing factors to fiscal space availability and discusses recent developments. Assuming a continuation of low interest rates, it is unlikely that fiscal space will constrain short-term federal operations, but projections indicate that fiscal space may be a binding constraint in the medium- and long-term outlook.

Recent Trends

The legacy of persistent budget deficits in the last several decades has been a steady accumulation of publicly held debt relative to GDP. Figure 1 shows the historical movement in publicly held federal debt from FY1946 to FY2016. Debt held by the public declined after World War II but has since increased considerably, rising from 23.1% of GDP in FY1974 to 76.6% of GDP in FY2016. This trend included a significant rise in debt held by the public during the 2007-2009 Great Recession and subsequent recovery, from 35.2% of GDP in FY2007 to 70.4% of GDP in FY2012. The rate of increase slowed in the past few years due to further economic improvements, expiration of recovery programs and certain tax cuts, and restrictions on discretionary spending.

Figure 1. Publicly Held Federal Debt, FY1946-FY2016
Unlike many state and local governments, the federal government has no statutory balanced-budget requirement. Persistent deficits nevertheless face a long-term binding constraint—the willingness of investors to finance them. If deficits are too large, publicly held debt would grow more quickly than the economy. At some point, debt would become so large that investors would no longer be willing to finance deficits and fiscal space would be exhausted. As discussed below, there is great uncertainty about when investors would stop financing federal borrowing.

The amount of fiscal space available depends on both the current size of the debt and how fast it is increasing relative to GDP. The latter depends on the size of deficits, the government's borrowing rate, and how quickly the economy is growing.

The debt doubled after the financial crisis from a relatively low base. In hindsight, we can observe that we were not close to exhausting fiscal space in 2007 because the subsequent increase did not lead to higher interest rates or a funding crisis. But now that the debt has more than doubled, less fiscal space is likely available.

Current projections forecast continued increases in the debt to GDP ratio under current law. The current Congressional Budget Office (CBO) baseline estimates that debt held by the public will rise to 85.5% of GDP in FY2026, with deficits persistently exceeding their postwar average (2.1% of GDP). CBO's most recent Long-Term Budget Outlook projects that publicly held debt will reach 141.1% of GDP in FY2046. It is unclear if investors would be willing to continue financing debt at those levels; the only other time debt levels as a share of GDP exceeded 100% was during World War II. Long-term forecasts are subject to significant uncertainty. Risks to the forecast that could result in less fiscal space
than anticipated include future recessions, future wars, a continuation in the economic growth slowdown, a return to average historical interest rates, or a return to average historical growth in health costs.

Because the reaction of investors to future increases in the debt is unknown, it is difficult to estimate when fiscal space will run out—although that point is presumably far off in the future, given interest rates are currently low. Recent international experiences speak to the complexity of fiscal space. Both Greece and Japan experienced rapid growth in government debt in the past decade. OECD data on general government debt (including municipal government debt) indicates that Greek debt rose from 115% of GDP in 2006 to 179% of GDP in 2014, while Japanese debt rose from 180% of GDP to 247% of GDP over the same time period. A loss in market confidence in Greek debt led to a severe recession, with GDP contracting by 9 percentage points in 2011 and long-term interest rates reaching 22% in 2012. Japanese borrowing was viewed to be more sustainable despite being higher, with relatively flat GDP levels and long-term interest rates close to zero in recent years. Among 31 OECD countries, the United States had the sixth largest level of general government debt in 2014, the most recent year for which full data are available.

Policy Implications

Whether one favors larger or smaller deficits, the market constraint on borrowing has implications for the optimal size and timing of future deficits. Further deficit reduction in the current economic expansion would give policymakers more fiscal space to use fiscal policy (increases in the deficit through higher spending or lower taxes) to counteract the next downturn or for new policy initiatives. Alternatively, creating more fiscal space now would reduce the risk of inadvertently running out of fiscal space in the future.

The benefits of creating more fiscal space dovetail with the macroeconomic benefits of deficit reduction if the economy is near full employment, as the length of the expansion and the current unemployment rate would seem to indicate. Deficit reduction near full employment can help prevent the economy from overheating and avoid "crowding out" of private investment, which would have positive implications for intergenerational equity and long-term growth. However, some economists believe that there are forces preventing the economy from reaching full employment, such as underlying "slack" in the labor market or "secular stagnation." If so, the macroeconomic argument for deficit reduction would be less clear cut. For more on the use of fiscal space across business cycles, see CRS Insight IN10623, The Federal Budget Deficit and the Business Cycle, by Grant A. Driessen and Marc Labonte.