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# Tracking Budget Surpluses

Like all of us, the government's income and spending don't always match. Sometimes the government spends more money than it takes in—a budget *deficit*. When the opposite occurs, and the government's revenue exceeds expenses, that is known as a budget *surplus*. Sounds simple, but predicting how long a deficit or surplus will last and which one will occur from year to year has proved to be a complex task for economists.

After running deficits that averaged almost $200 billion a year from 1989 to 1997, the federal government recorded a budget surplus of $69.2 billion in fiscal year 1998—the first surplus in more than 25 years. Over the next two years, as the economy strengthened, the federal surplus nearly quadrupled, rising to just under $240 billion in fiscal year 2000. In May 2001, the Congressional Budget Office (CBO) projected that it expected this trend to continue in the form of federal surpluses totaling just over $5.6 trillion between fiscal years 2002 and 2011.

## Unforeseen Obstacles

These CBO projections were based on the assumptions that the economy would continue to grow robustly, with no new tax cuts or increases in government spending. Given that trillions of dollars are involved, even small errors in these assumptions about economic conditions have the potential to become quite large when compounded over a decade. In fact, as late as 1997, the CBO and most private forecasters were projecting large and rising budget *deficits* over the next decade.

Of course, the CBO could not have foreseen the events of Sept. 11, the subsequent war on terrorism and the 2001 recession. And while budget forecasters might have surmised from the 2000 presidential campaign that, if elected, George W. Bush planned to pursue cuts in marginal tax rates, the rules of the game prevented forecasters from adjusting their budget projections accordingly. In its January 2002 report, the CBO now projects that federal surpluses for fiscal years 2003 to 2012 will add up to about $2.2 trillion, with small deficits projected for 2002 and 2003.

## Hitting Full Stride

Government finances typically deteriorate during recessions. When the economy weakens, it slows down the growth of incomes—and, as a result, tax revenues. Meanwhile, expenditures on unemployment insurance and other income-support programs tend to increase. This effect can be compounded during times of war. In 2001, the U.S. economy experienced all of these conditions, and the end result was no surprise: Government surpluses at the federal, state and local levels diminished markedly. Because government budget balances tend to move in tandem with the economy, it seems reasonable to conclude that the fiscal outlook will improve once the turmoil of war and recession passes.

On average, federal budget balances as a percentage of GDP (gross domestic product) fall by about 2 percent during recessions. The deterioration in state and local budget balances as a percentage of GDP is much less—0.3 percent, which is expected given their balanced-budget requirements. Nonetheless, state and local government finances did benefit from strong U.S. economic growth during the late 1980s and early 1990s. During that period, total state and local government receipts grew by an average of 7.5 percent a year, while expenditures were rising by an average of 7.7 percent a year. From 1995 to 2000, the situation reversed: Growth of state and local revenues averaged 5.9 percent a year, while their expenditures increased by 5.7 percent a year. Accordingly, budget surpluses built up. In response, net tax reductions occurred at the state level each year for fiscal years 1995 to 2001.

## Down the Stretch

As the economy turned down in late 2000, state and local budgets once again came under increasing pressure. As the growth of tax revenues slowed dramatically, many states—most of which operate under some sort of balanced-budget requirement—were forced to trim planned outlays, raise taxes and/or redirect money from "rainy day" funds.

At the state and local level, policymakers are struggling to cope with large increases in Medicaid spending. From 1987 to 2000, state spending on Medicaid had risen by nearly 12 percent a year, outstripping the percentage growth of all other major expenditures. As a result, Medicaid is now the second-largest expenditure of state governments, just behind spending on elementary and secondary education. An additional uncertainty is the extent to which federal resources will be diverted to state and local governments to implement several of the new initiatives designed to enhance homeland security.

At the federal level, the budget balance may improve this year. During the early phase of an economic expansion, the federal government's budget balance typically increases by approximately 1.3 percent of GDP. In other words, tax revenues typically grow faster than do government expenditures in the early phase of an expansion. Thus, if forecasters are correct in their assessment of how strong the economy will be in 2002, the federal budget could end the year in the black.

*This article was adapted from "Government Budget Surpluses Head South," which was written by Kevin L. Kliesen and appeared in the April 2002 issue of* The Regional Economist, *a St. Louis Fed publication.*

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# Q & A

**What is the *Beige Book*?**

Each Federal Reserve bank gathers information about economic conditions in its district through a network of contacts. Prior to each of the eight scheduled Federal Open Market Committee (FOMC) meetings, this anecdotal survey information (reported by district and sector) is compiled into the Summary of Commentary on Current Economic Conditions, commonly known as the *Beige Book* because of its plain beige cover.

**Who puts the *Beige Book* together?**

The 12 district reports are gathered by one of the 12 Reserve banks on a rotating basis. That bank's staff prepares the national summary of economic conditions.

**Is the information in the *Beige Book* made public?**

The information can be found on the Federal Reserve Board's web site at http://www.federalreserve.gov/fomc/beigebook/2002/default.htm and is also reported by the news media on each release date.

**Why is the information in the *Beige Book* valuable?**

Anecdotal information can be used to confirm or to help understand ongoing trends that arise from formal data or to identify emerging trends. Regional information may provide insight into the business cycle if the economy is experiencing a "rolling recession" that bottoms out in different regions at different times. Also, the *Beige Book* can help develop a picture of state and regional economic conditions, for which there is less data than for national trends. In addition, some one-time events, such as Y2K and the terrorist attacks of 9/11, do not fit into formal economic models. Talking with business leaders to discern their plans provides information about the economy's reactions to such events.

**Why doesn't the Fed rely strictly on formal data?**

The Fed's basic picture of the economy does come from formal data published by statistical agencies. Unfortunately, the formal data lag current economic conditions. Anecdotal information helps the Fed to see what is going on in the economy almost as it is happening. Also, because this information is collected from the people who are actually making day-to-day business decisions, it helps the Fed understand why trends in the data are occurring.

*The content for Q & A was adapted from "Color Me Beige" which was written by Howard J. Wall, research officer at the Federal Reserve Bank of St. Louis, and appeared in the February 2002 issue of* National Economic Trends*, a St. Louis Fed publication, and "The Role of Anecdotal Information in Fed Policymaking", a speech delivered Feb. 13, 2002, by William Poole, president and CEO of the Federal Reserve Bank of St. Louis.*

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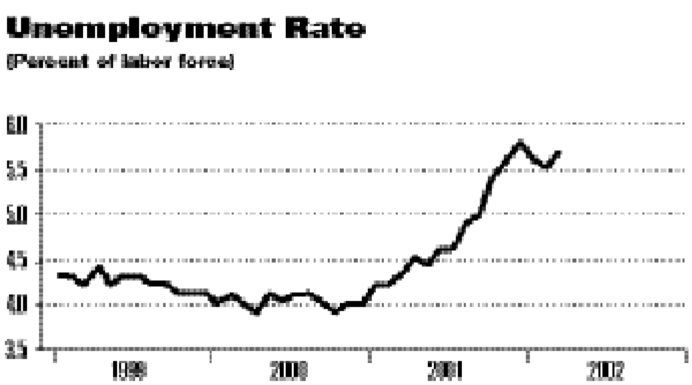
# Economic Snapshot

## 1st Quarter 2002

| | Q2-01 | Q3-01 | Q4-01 | Q1-02 |
|---|---|---|---|---|
| **Growth Rate—Real Gross Domestic Product** | 0.3% | -1.3% | 1.7% | NA* |
| **Inflation Rate—Consumer Price Index** | 3.1% | 0.8% | -0.3% | 1.4% |
| **Civilian Unemployment Rate** | 4.5% | 4.8% | 5.6% | 5.6% |

**Not available*




Graph from April 2002 issue of *National Economic Trends*.

## Who is counted as employed?

According to the Bureau of Labor Statistics, people are considered employed if they did any work at all for pay or profit during the week in which the employment survey was conducted. This includes all part-time and temporary work, as well as regular full-time, year-round employment.

## Who is counted as unemployed?

Civilian, noninstitutional persons 16 years of age or older are classified as unemployed if they do not have a job, have actively looked for work in the prior four weeks and are currently available for work.