

The Current Account Deficit and the Budget Deficit:
Is \$600 Billion Missing?

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Executive Summary

This paper examines the impact of the persistence of a large current account deficit on the budget deficit. The U.S. is currently running a current account deficit of approximately \$550 billion or 5 percent of GDP. This deficit corresponds to a transfer of \$550 billion in U.S. financial assets, such as stocks, bonds, and short-term deposits, to foreign wealth holders. The interest, dividends, and capital gains earned on these assets in subsequent years will accrue to foreigners and will therefore largely escape domestic taxation.

The paper notes that while the economic projections assume, either explicitly or implicitly, that the current account deficit remains near its present level, the Congressional Budget Office's (CBO) budget projections appear to have ignored the implied reduction in taxable income.

This error is similar to the failure of CBO to recognize the inconsistency between its projections of capital gains tax revenue in 2001 and its projections for profit growth. The projections for capital gains tax revenue implicitly assumed that stock prices would continue to rise, even from record price to earnings ratios, in spite of the fact that profits were projected to grow at a very slow pace. As a result of this error, the 2001 CBO projections of capital gains tax revenue over the period 2001-2011 were \$526 billion higher than the most recent projections.

The failure to incorporate the impact of the current account deficit is likely to lead to an overstatement of revenue of approximately the same amount. The paper shows that if the annual current account deficit remains near \$500 billion for the next decade, then the deficits will be considerably larger than the projections indicate. The gap will increase each year. In 2014, the last year in the projection, the deficit will be nearly \$85 billion, or 0.5 percent of GDP, higher than the current CBO projections show. Over the full ten-year horizon, the current account deficit will add \$587 billion to the debt, an amount a larger than the cost of the Medicare prescription drug benefit.

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It is widely recognized that budget projections are heavily dependent on underlying economic projections. Growth that is substantially more or less rapid than baseline projections can have a large impact on tax revenue and therefore the deficit or surplus. There is always an element of uncertainty in these growth projections – budget planners simply have to make their best guess based on the available evidence. While there are always reasons for arguing that any specific growth projection should be higher or lower, ultimately the growth rate used as a baseline is a judgment call.

However, in some cases budget projections have been based on economic projections that were clearly inconsistent. In such situations, the projections should be corrected in order to be made consistent. This is a question of logic, not judgment. The current projections from both the Congressional Budget Office (CBO) and the Office of Management and Budget are inconsistent in this manner, because they fail to incorporate the impact of the current account deficit. As a result of this inconsistency, the most recent projections are likely understating the cumulative federal budget deficit over the next decade by close to \$600 billion.

This is not the first time that such inconsistencies have led to erroneous budget projections. The most important recent example of this sort of inconsistency was the projection for capital gains tax revenue that CBO made as the stock bubble was reaching its peak. For example, in its 2002-2011 *Budget and Economic Outlook*, which was published when the stock bubble was still near its peak in January of 2001, CBO projected that the government would collect \$1,240 billion in tax revenue over period from 2001 through 2011 (table 3-6). In the current *Budget and Economic Outlook*, CBO projects that capital gains tax revenue over this period will be just \$714 billion (table 4-4), a difference of \$526 billion.

While a portion of this difference is attributable to the recent reduction in the capital gains tax rate, the vast majority of the falloff is due to the fact that capital gains realizations are now projected to be far lower over this period than was the case in 2001. The cumulative difference between the 2001 projection for realization of gains over the 2001-2011 period and the projection in the most recent *Budget and Economic Outlook* is \$2,093 billion. Table 1 shows the projections for capital gains realizations and tax revenue from the *Budget and Economic Outlooks* published in January of 2001 and January of 2004.

The fact that the CBO vastly overestimated capital gains realizations was not simply bad luck. The CBO projections at the time implicitly assumed that the stock bubble would persist, with price to earnings ratios remaining at record levels. (Unlike the New Economy optimists at the time, CBO projected a very modest pace of real profit growth, just 1.0 percent annually.) CBO's implicit projection, that the price to earnings ratio would remain nearly constant, and therefore that there would be no stock crash, effectively assumed that investors would be willing to hold stock at very low real rates of return. With the dividend yield (including share buybacks) falling under 2.0 percent, the

Table 1
CBO Projections of Capital Gains

| | Realization Projections | | Revenue Projections | | Difference |
|--------------|--------------------------------|-----------------|----------------------------|-----------------|--------------|
| | 2001 Projection | 2004 Projection | 2001 Projection | 2004 Projection | |
| | Billions of dollars | | | | |
| 2001 | \$652 | \$349 | \$129 | \$100 | \$29 |
| 2002 | 619 | 256 | 125 | 57 | \$68 |
| 2003 | 593 | 274 | 119 | 45 | \$74 |
| 2004 | 574 | 328 | 114 | 44 | \$70 |
| 2005 | 561 | 363 | 110 | 49 | \$61 |
| 2006 | 553 | 397 | 107 | 54 | \$53 |
| 2007 | 551 | 429 | 106 | 59 | \$47 |
| 2008 | 554 | 531 | 106 | 64 | \$42 |
| 2009 | 560 | 378 | 106 | 76 | \$30 |
| 2010 | 571 | 475 | 108 | 76 | \$32 |
| 2011 | 586 | 501 | 110 | 90 | \$20 |
| Total | \$6,374 | \$4,281 | \$1,240 | \$714 | \$526 |

Source: Congressional Budget Office, 2001 (table 3-6) and 2004 (table 4-4).

implied real return on stock would be less than 3.0 percent, assuming that the price to earnings ratio remained constant.

At the time, the real return available on a completely safe, inflation indexed, government bond was over 3.5 percent. It was inconsistent to assume that investors would be willing to hold stock for a return that was lower than the return that was available on a completely safe asset. As was noted at the time, CBO should have recognized that its profit growth projections implied a crash of the stock bubble and therefore lowered its capital gains tax projections accordingly.²

While any projection for growth can prove wrong due to unforeseen events, there is no excuse for making inconsistent projections, as CBO did in the case of its 2001 projections for capital gains tax revenue. Just as CBO failed to assess the consistency of its 2001 projections for capital gains tax revenue and profit growth, it is currently failing to consider the impact of the current account deficit on the budget deficit.

² See Center for Economic and Policy Research, 2001, "CBO Budget Byte," [http://www.cepr.net/Bytes/cbo_budget_byte010131.htm] and Dean Baker, 2000, "The Costs of the Stock Market Bubble," Center for Economic and Policy Research, [http://www.cepr.net/stock_market/stock_market_bubble.htm].

Although projecting the exact impact of the current account deficit on the budget deficit involves assumptions that are subject to debate, the basic logic is unassailable. The fact that the United States is running a large current account deficit means that foreign investors are holding a greater portion of U.S. financial assets through time. The income from holding these assets (interest, dividends, and capital gains) accrues to foreign investors who are generally not subject to U.S. taxes. This means that taxable income will grow less rapidly than GDP. The CBO projections make no adjustment for this fact – they assume no change in the relationship between taxable income and GDP – even though the projections assume that the current account deficit will remain near its current 5.0 percent share of GDP.³

A simple calculation can give a rough approximation of the potential revenue loss due to the current account deficit. According to the most recent data from the Commerce Department, the current account deficit was running at an annual rate of \$550 billion in the first three quarters of 2003. This follows a sharp run-up from a deficit of \$128 billion in 1997. The recent decline in the dollar will likely limit any further increases, and possibly set the deficit on a downward path, but unless the U.S. economy falls into another recession, it is unlikely that there will be a sharp reversal in the current account deficit in the immediate future.

Table 2 shows the budgetary impact of a current account deficit of \$500 billion annually over the next decade. The assumptions used to construct table 2 are explained in the appendix. The loss of taxable income due to increased foreign ownership of U.S. assets is shown in column B. This loss is assumed to increase by \$25 billion each year, based on the annual increase in the net foreign holdings of U.S. assets. The loss of tax revenue is assumed to be 20 percent of the decline in taxable income. There is also an additional interest burden due to the greater rate of debt accumulation. This additional annual interest burden is shown in column D. The annual interest is assumed to be equal to 5 percent of the additional debt that results from the sustained current account deficit over this period, which is shown in column E.

By the end of the period in 2014, the increase in the annual deficit as a result of the sustained current account deficit will be nearly \$85 billion, or approximately 0.5 percent of projected GDP, \$60.5 billion from lost tax revenue and \$23.9 billion in higher interest payments. The cumulative increase in the debt over this period is projected to be \$586.8 billion, an amount that is larger than the original estimate of the cost of the projected Medicare prescription drug benefit.

These projections are highly speculative. There are reasons for believing that the actual impact of the current account deficit on the budget deficit could be either higher or lower, but the potential impact is large compared to many other items that are included in the budget projections. While it would be worth producing more careful projections of this

³ This assumption is stated explicitly in the Economic and Budget Outlook 2004-2013. The most recent edition does not comment on the topic, but it does not assume a large decrease in the value of the dollar, which is the only plausible mechanism for substantially reducing the current account deficit.

Table 2
Impact of the Current Account Deficit on the Budget Deficit

| | A | B | C | D | E |
|------|----------------------------|---|-------------------------------|--|---|
| | Current Account Deficit | Cumulative Loss of Taxable Income | Annual Loss of Tax Revenue | Additional Interest from Higher Debt | Cumulative Increase In Federal Debt |
| | Billions of dollars | | | | |
| 2003 | \$550 | \$27.5 | \$5.5 | \$0.0 | \$5.5 |
| 2004 | 500 | 52.5 | 10.5 | 0.3 | 16.6 |
| 2005 | 500 | 77.5 | 15.5 | 0.8 | 33.7 |
| 2006 | 500 | 102.5 | 20.5 | 1.7 | 57.6 |
| 2007 | 500 | 127.5 | 25.5 | 2.9 | 88.8 |
| 2008 | 500 | 152.5 | 30.5 | 4.4 | 128.2 |
| 2009 | 500 | 177.5 | 35.5 | 6.4 | 176.5 |
| 2010 | 500 | 202.5 | 40.5 | 8.8 | 234.7 |
| 2011 | 500 | 227.5 | 45.5 | 11.7 | 303.7 |
| 2012 | 500 | 252.5 | 50.5 | 15.2 | 384.5 |
| 2013 | 500 | 277.5 | 55.5 | 19.2 | 478.5 |
| 2014 | 500 | 302.5 | 60.5 | 23.9 | 586.8 |

Source: Author's calculations: see appendix.

impact, the projections in Table 2 should be sufficient to show that a consistent projection of the deficit over the budget horizon is likely to be considerably higher than is generally recognized.

There is no excuse for not explicitly incorporating the impact of the current account deficit in official deficit projections. The failure to include consistent projections of stock returns at the peak of the bubble in 2001 led to a considerable overstatement of capital gains tax revenue over the next decade. Failing to incorporate the impact of a large current account deficit, and the increasing portion of capital income accruing to foreign wealth holders, can lead to an overstatement of revenue, and therefore an underestimate of the deficit, of a comparable magnitude.

Appendix

The table assumes that the current account deficit falls from its 2003 level of approximately \$550 billion, to \$500 billion in 2004. The calculations assume that the current account deficit then stays at \$500 billion annually over the next decade. The assumption that the current account remains constant at this level implies a substantial reduction in the trade deficit over this period, since annual interest payments are assumed to be rising at an annual rate of \$25 billion a year. This leads to a situation in which the annual trade deficit falls to just under \$200 billion annually by 2014, or approximately 1.1 percent of GDP. This compares to a trade deficit of approximately 4.5 percent of GDP in 2003. It is possible that a sharp decline in the dollar, or a recession, will lead to a more rapid reduction in the current account deficit, but neither of these events are assumed in the CBO projections.

The projected reduction of 1.5 percentage points in the share of GDP that is subject to domestic taxes, is somewhat larger than the 1.0 percentage point reduction over the last quarter century. In 1979, the Gross National Product, which includes earnings on holdings of foreign financial assets, was approximately 1.0 percent larger than GDP. These projections imply that in 2014, GNP will be approximately 1.5 percentage points smaller than GDP. A more rapid decline in GNP relative to GDP is consistent with the extraordinarily large current account deficits that the U.S. has been running in recent years and is assumed to run in the future in these projections.

The calculations assume that foreign investments earn an average annual return of 5.0 percent, which is equal to a real return of approximately 2.8 percent given CBO's inflation projections. A substantial portion of foreign assets is currently invested in short-term deposits which pay very low interest rates. This has led to very low returns on foreign holdings of U.S. assets in recent years. However, this situation is likely to change over the decade for two reasons. First, interest rates are projected to rise, according to CBO projections – even short-term deposits are projected to receive a 3.0 percent return over the period 2006-2014. Second, the portion of the foreign assets held as short-term deposits is likely to fall as total holdings increase. This is especially true since many countries already have extremely large holdings of dollar reserves and are unlikely to substantially increase these holdings in future years. With foreign assets shifting to longer term assets (e.g. stocks and bonds) that pay considerably higher rates of return, the assumption of a 5.0 percent average return may prove too low.