Putting the brakes on cutting the deficit

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With all the haggling over tax increases and spending cuts to avert the fiscal cliff, is it possible the federal budget deficit is shrinking too fast?

The question is jarring. The deficit, when measured against the size of the U.S. economy, has been bigger in each of the past three years than in any year since 1945. Total federal debt is above $16 trillion and brushing up against the congressionally set ceiling. Even under optimistic economic forecasts, the debt burden will grow without a change in tax and spending trends.

But . . .

The deficit — the difference between government revenue and spending — is shrinking even before the year-end fiscal cliff or a last-minute compromise to avoid it. In the depths of the most recent recession, the fiscal year that ended Sept. 30, 2009, the deficit was 10.1% of gross domestic product, the value of all the goods and services produced. Since then, the deficit has declined to 9% of GDP in 2010, 8.7% in 2011 and 7.0% in fiscal 2012. Private analysts predict the deficit will be between 5.5% and 6.0% of GDP in fiscal 2013, depending on the outcome of the budget talks.

One reason the deficit is still large is that the economy is still lousy: More unemployment means fewer taxpayers as well as more government spending on jobless benefits, food stamps and the like. As the economy slowly improves, the deficit shrinks as these automatic stabilizers, as they're known, adjust. Tax revenue rises. Safety-net spending falls. The U.S. budget deficit has been coming down at roughly the same pace as the U.K.'s — with far less austerity than Britain's David Cameron has prescribed and substantially better growth.

That isn't the whole story. To gauge the impact of fiscal policy, economists estimate what the budget deficit would be if the U.S. were at close to full employment and if the unemployment rate were around 5.4%. In budget geeks' nirvana, the "cyclically adjusted" deficit should be close to zero when the economy is firing on all cylinders. Though healing, the U.S. economy remains far from healthy. At 7.7%, unemployment is roughly where it was at the depths of the 1990-91 recession and well above its peak during the 2001 recession.

The "structural" measure of the deficit has been coming down, too. It fell by about 1.3 percentage points of GDP in 2012, or roughly by $200 billion. It isn't only the improving economy that is automatically reducing the deficit, it is the retreat in federal stimulus spending and cuts by state and local governments. After the huge fiscal stimulus of a few years ago which offset the contraction in consumer and business demand, government has gone into reverse: It now is a drag on growth, and that is likely to continue in 2013.

OK, you might say, what's the problem? Haven't we been told by everyone from Standard & Poor's and the Congressional Budget Office to Erskine Bowles that the U.S. budget is on a dangerously unsustainable trajectory? Aren't business executives complaining that uncertainty about tax increases and spending cuts is hurting the economy? So, the faster the deficit shrinks, the better, right? Not necessarily.

There is an argument for going cold turkey, which says that delaying austerity merely prolongs the pain. There also is the case that aggressively reducing a government's budget deficit removes uncertainty about tax increases and can unleash a burst of economic energy. There are times — though surely not now —

when fiscal austerity allows a central bank to cut interest rates.

And, of course, when markets turn against a government's debt, as they have in Italy and Spain, there are few alternatives to instant austerity.

But consider the U.S. economy at the end of 2012. The U.S. Treasury, for now, is borrowing hundreds of billions of dollars at rock-bottom interest rates. There is no pressure from markets for immediate deficit reduction. The U.S. economy has been and is expected to grow at a painfully slow pace. Four months ago, forecasters surveyed by The Wall Street Journal expected the economy would expand by 2.5% over the four quarters of 2013. This week, they are predicting 2.3% — and they expect unemployment to be above 7% until mid-2014. That is why the White House is looking for ways to slip a little infrastructure spending into any deficit deal or otherwise give the economy a short-term boost.

Federal budget deficits do threaten American prosperity — tomorrow. Waiting until tomorrow to enact laws to change benefits so their costs rise more slowly and to alter the tax code so it brings in more revenue would be imprudent. But an overdose of instant austerity would be, too.