The Great Recession of 2008-2009 will be remembered for its severity—a cumulative decline of 4.2 percent in real GDP, the loss of 8.7 million jobs, and a harsh toll on the banking system with more than 400 bank failures from 2008 to 2011. The Great Recession should also be remembered for the massive increase in the federal budget deficit it spawned. As a percentage of GDP, the budget deficit reached 9.8 percent in fiscal year 2009, the highest since 1945 and the highest ever excluding the World War II period (Chart 1). Through another lens, the six-year cumulative deficit from 2008 to 2013 totaled almost 41 percent of GDP, well exceeding the total of about 26 percent for the six worst years of the Great Depression.

Like the proverbial double-edged sword, fiscal deficits can be both helpful and detrimental. The positive aspect is that the strong federal fiscal response likely helped initially to support the recovery. The negative side is that the nation’s cumulative debt position deteriorated, raising concern about the long-term outlook for the economy. In addition, very large deficits cannot be maintained indefinitely, and as expenditures are reduced, they tend to restrain economic growth.

Recently, the deficit has been shrinking thanks to a combination of increased federal revenues and expenditure restraint. Though expenditure restraint has been a drag on GDP, the drag is diminishing. Overall, we expect the economy to continue to grow regardless of the short-term trends in fiscal policy. However, we remain concerned about the long-term projections for federal deficits and the cumulative debt.
**REVENUE PROJECTIONS**

Total federal revenues fell 1.7 percent in 2008 and 16.6 percent in 2009. Since then, revenues have posted four consecutive years of increases including a 13.3 percent rise in 2013. These increases reflect the improving economy, as more tax revenue flows into the Treasury with better jobs growth, wage increases, and GDP growth. The Congressional Budget Office (CBO) projects an 8 percent increase for fiscal 2014 and a 9 percent gain for 2015. After that, revenues are expected to post average growth of roughly a 4.4 percent through 2024 (Chart 2).

As shown in Chart 3, among the components of federal revenues, individual income taxes make up the lion's share (47 percent as of 2013), followed by social insurance and retirement programs (34 percent), corporate income taxes (10 percent), and other taxes (9 percent).

Chart 4 shows the growth by source for each year through 2024. Over the projection period, revenues from individual income taxes are projected to grow at an average rate of 6.0 percent, the fastest among the major sources. That faster growth rate will push the share of revenues from individual income taxes to 51 percent by 2024. Social insurance and retirement programs will fall to 32 percent—making a combined 83 percent share for workers, while other taxes will decline to a 7 percent share. The corporate tax share is projected to remain at 10 percent (Chart 3).
EXPENDITURE PROJECTIONS
On the expenditure side, federal outlays surged almost 18 percent in 2009 as the government sought to fight the ongoing recession. Without commenting on the political process that produced recent budgets, debates over the federal budget since then have resulted in a series of sequestration cuts, producing declines in federal outlays in three of the five years from 2010 to 2014. These declines have weighed on economic growth, restraining the pace of recovery. Beyond 2014 this restraint should ease, as expenditures are expected to grow by an average of about 5.2 percent per year through 2024, comparable to the average growth in expenditures from 1985 to 2007 (Chart 5). Most of the growth is expected to be in either mandatory spending programs or net interest expense (Charts 6 and 7).

ECONOMIC OUTLOOK
Our Business-Cycle Conditions (BCC) index was slightly lower in the latest month. The share of leading indicators that expanded was 87.5 percent in September, a drop of 2.5 percentage points from a reading of 90.0 percent in August.

Our cyclical score for the leading indicators, declined to 84 in September from 90 in August. With both our leaders’ index and cyclical score well above 50, the economic outlook remains positive.

Key takeaways include:

**Leading**: Among the 12 leading indicators, seven were judged as “clearly expanding” in September, four were considered “indeterminate” and one was
“clearly contracting.” Among those indicators that were clearly expanding, five hit new cycle highs: yield curve index, new orders for consumer goods, new orders for core capital goods, index of common stock prices, and initial claims for state unemployment insurance (inverted).

**Coincident:** Five of our coincident indicators continued to expand in September, resulting in a 100 reading for the 33rd consecutive month. Within these five indicators, three hit new cycle highs: nonagricultural employment, manufacturing and trade sales, and Gross Domestic Product.

**Lagging:** AIER’s index of lagging indicators registered a perfect 100 percent reading again last month as five out of five indicators with a trend were clearly expanding; four of them hit new cycle highs for the month. Those expanding were: average duration of unemployment, manufacturing and trade inventories, commercial and industrial loans, the ratio of consumer debt to income, and change in labor costs per unit of output in manufacturing.

**In aggregate:** Seventeen of our 24 indicators were judged to be expanding last month, with 12 hitting new cycle highs. Six indicators were considered to have no discernable trend, while just one indicator was contracting. Overall, our three composite indexes remained well above 50 percent, pointing to continued economic growth in the quarters ahead (Chart 8).

**CONCLUSIONS**

The short-term outlook for the economy remains favorable according to our Business Cycle Conditions indicators. Our Diffusion Index of Leaders and cyclical score both remain well above 50, suggesting a low probability of recession in coming quarters.

The federal budget deficit is shrinking but remains elevated by historical standards. There continues to be a net drag on GDP growth from fiscal policy, but the drag is diminishing.

Overall, fiscal policy is likely to have minimal impact on the economic recovery, though current longer-term projections of debt and deficits by the CBO are more worrying. While there are no clear points at which deficits and debt levels become destabilizing forces, excessive debt poses a potentially significant risk as it reduces the federal government’s capacity to respond to unexpected events. With current CBO projections suggesting a cumulative-debt-to-GDP ratio approaching 80 percent by 2024 (Chart 1), more attention needs to be directed towards fiscal policy.
APPENDIX: PRIMARY LEADING INDICATORS

Sources for all charts on page 5 and 6: Federal Reserve Board, Institute for Supply Management, Census Bureau, Bureau of Economic Analysis, The Conference Board, Standard & Poor's, Department of Labor, Bureau of Labor Statistics/Haver Analytics, AIER.
APPENDIX. PRIMARY ROUGHLY COINCIDENT INDICATORS

Nonagricultural Employment (1) (millions)

Index of Industrial Production (1) (2007 = 100)

Personal Income Less Transfer Payments (1) (constant $, billions)

Manufacturing and Trade Sales (2) (constant dollars, billions)

Civilian Employment as a % of the Working-Age Population (2)

Gross Domestic Product (1) (quarterly, constant dollars, billions)

APPENDIX. PRIMARY LAGGING INDICATORS

Average Duration of Unemployment (2) (weeks, inverted)

Ratio of Consumer Debt to Personal Income (1) (percent)

Manufacturing and Trade Inventories (1) (constant dollars, billions)

% Chg. from a Year Earlier in Mfg. Labor Cost per Unit of Output (2)

Commercial and Industrial Loans (1) (constant dollars, billions)

Composite of Short-Term Interest Rates (1) (percent)

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Business-Cycle Conditions is published by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization.

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