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Reducing the U.S. Government's Budget Deficit

In recent months, we have heard quite a bit about the importance of reducing the U.S. government's budget deficit and about the necessity of raising the debt ceiling. These two ideas are related because a budgetary deficit means that government spending is more than revenues, and the government must borrow the difference. As long as the federal government runs a deficit, its indebtedness continues to grow. Because the federal government has set a ceiling on the amount of debt it allows itself to have, it is occasionally forced to raise the ceiling to accommodate its accumulating debt. Such an occasion gives us a time to pause and consider the directions of government spending, revenues and the rate at which the U.S. government debt is accumulating.

Over the 40-year period from 1971 to 2010, U.S. government spending averaged 20.8 percent of U.S. gross domestic product (GDP) and its revenues averaged 18 percent of GDP. The resulting budget deficit averaged 2.8 percent of U.S. GDP. Federal government budget deficits surged to $1.4 trillion in 2009 and $1.3 trillion in 2010, representing 10.0 percent and 8.9 percent of U.S. GDP, in the respective years. These are the largest percentages for deficit spending since 1945 when the United States was closing out World War II. The financial turmoil, recession and weak economic recovery combined with the policies designed to combat those economic problems has contributed to the budget deficits, but some of the imbalance between revenues and spending predates the recession.

An Outlook for Rising U.S. Government Indebtedness

As a result of the large budget deficits, the federal government debt has soared. At the end of fiscal year 2007, the U.S. government debt held by the public totaled $5 trillion or 36 percent of U.S. GDP—a figure just below the 37 percent average for the 40 year period from 1971 to 2010. As of mid-2011, the U.S. government debt held by the public totaled about $10 trillion or 67 percent of U.S. GDP—the highest figure since shortly after World War II. With the federal government spending and revenues projected under current laws, the Congressional Budget Office (CBO) expects that over the next ten years revenue will cover slightly less than 85 percent of federal government spending, and the U.S. government debt will rise to 77 percent of U.S. GDP by 2021.

This outlook assumes that temporary measures that reduce taxes (such as the Bush tax cuts, extended in 2010) will be allowed to expire, new measures that will reduce taxes (such as indexing the alternative minimum tax for inflation) will not be implemented, and that existing measures to cut spending (such as the scheduled cut to Medicare payments for physician services) will be implemented. If the Bush tax cuts are further extended, the alternative minimum tax is indexed for inflation, and the scheduled cut in Medicare payments for physician services are not implemented, CBO projects that the U.S. government debt will rise to 97 percent of U.S. GDP by 2021.

A projected federal government debt of 77 to 97 percent of GDP is alarming. Such a rate of indebtedness is close to that occurring during World War II, when the federal government was borrowing to pay for a war. According to the Congressional Budget Office, "If federal debt continues to expand faster than the economy—as it has since 2007—the growth of people's income will slow, the share of federal spending devoted to paying interest on the debt will rise more quickly, and the risk of a fiscal crisis will increase." In addition, the interest rates paid by the government are likely to rise as the debt continues to grow relative to the nation's GDP. Investors will require the federal government to pay higher interest rates on its securities to compensate for risk that they might not be paid or that the value of securities will be eroded by higher inflation. The experiences in other countries with high government debt suggests that a loss in investors' confidence can occur abruptly and is most likely during an economic downturn when policymakers are already confronted with difficult policy options.

Bringing the U.S. Government Deficit under Control

If Congress wants to bring the federal deficit under control and prevent an escalation of U.S. indebtedness relative to our ability to pay, it must see that the annual deficit is less than the growth of U.S. GDP. That will require measures to cut spending and/or increase revenues. One of the major challenges in cutting spending is that defense, interest payments on the debt and entitlements programs accounted for 81 percent of federal government spending in 2010 and are projected to account for 87 percent of federal government spending in 2021. These entitlement programs include Social Security, Medicare, and Medicaid, most Veterans' Administration programs, federal employee and military retirement plans, unemployment compensation, food stamps, and agricultural price support programs.

The remainder of federal government spending, discretionary nondefense spending, was 19 percent of the total in 2010 and is projected at only 13 percent in 2021. Discretionary nondefense spending includes such programs as education, training, employment and social services; law enforcement and justice; highway infrastructure; highway and motor carrier safety; public transit; airport infrastructure programs; the national park system; environmental protection; science and technology; disaster relief; community and regional economic development; agriculture programs; energy programs; data collection; international affairs; foreign aid; and general government.

Over the next ten years, CBO projects that current laws will result in total federal government spending growing more slowly than U.S. GDP—shrinking from 24.7 percent of U.S. GDP to 24.0 percent—but remaining higher than the 40-year average of 20.8 percent established from 1971 to 2010. Entitlements programs will be 14.0 percent of U.S. GDP in both 2011 and 2021. Defense spending will decrease from 4.7 percent of U.S. GDP to 3.6 percent. Interest payments on the debt will increase from 1.5 percent of U.S. GDP to 3.3 percent. Discretionary nondefense spending will decrease from 4.4 percent of U.S. GDP to 3.1 percent.

At the same time, CBO projects federal government revenue will increase from 14.8 percent of U.S. GDP to 20.8 percent—absent measures to reduce future taxes, such as indexing of the alternative minimum tax or making the Bush tax cuts permanent. The former figure is well below the 40-year average of 18 percent established from 1971 to 2010, but the latter figure is higher.

Making the Changes

Those looking to balance the federal budget while holding government spending constant at the projected 24.0 percent of U.S. GDP need to raise taxes by almost 15.4 percent above those projected for 2021 and by almost 62.2 percent above those paid (as a percentage of GDP) in 2011. Similarly, those looking to balance the federal budget while keeping taxes from rising beyond 20.8 percent of GDP would need to cut government spending by nearly 13.3 percent. Those wanting to balance the federal budget while keeping taxes from rising beyond 14.8 percent of GDP would need to cut projected government spending by nearly 38.3 percent. The composition of the projected spending, the destructive effects of taxes on economic activity, and the extreme differences in the two approaches to balancing the budget explains why Congress is having difficulty crafting a long-term solution to meaningfully reduce the federal debt as a percentage of GDP.

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