# The Federal Budget: How the U.S. Got Here, and Where It Is Headed

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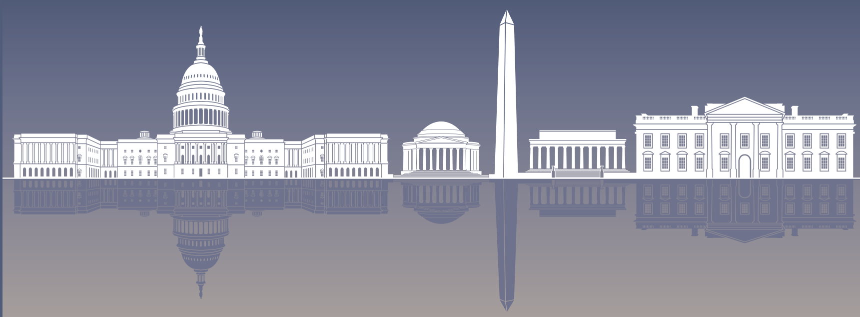



In response to the 2007-08 financial crisis and the recession that followed,[1] the federal government took a series of large-scale fiscal measures, which drove the deficit to unprecedented levels for the postwar period. These measures included, chiefly, the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009. Subsequent measures were undertaken to curb the growing deficit, such as the Budget Control Act of 2011, the American Taxpayer Relief Act of 2012 and the Bipartisan Budget Act of 2013. The political context during this period was characterized by significant turmoil, including ongoing debates on whether to raise the debt ceiling, uncertainty about the reversal of tax cuts, fears of a "fiscal cliff," etc.

The inevitable consequence of the large deficits since 2008 was a substantial increase in government debt as a percentage of gross domestic product (GDP), from 35 percent in 2007 to a projected 74 percent this year.[2] Arguably, the political discussion over fiscal issues has quieted down in recent months, and uncertainty about the federal budget outlook has greatly diminished. Thus, it seems timely now to study the overall fiscal response to the crisis and look at the implications of current budget projections for the next decade. The table displays major components of the federal budget, averaged over six periods since 1971. The source of the data is the Congressional Budget Office (CBO); included are projections for fiscal years 2014 until 2024.[3]

Federal revenue as a percentage of GDP peaked during the 1990s. Due to a series of tax provisions enacted throughout the 2000s, revenue in the period 2008-2014 was substantially below its historical average. Most of the drop was due to reductions in the tax rates imposed on individual income. In January 2013, these tax cuts were reversed for high-income earners, while they were made permanent for everyone else.[4] Revenue also fell because of the temporary reduction in the Social Security payroll tax for employees in 2011 and 2012. Moving forward, the federal government's revenue is projected to rise significantly, mostly due to scheduled increases in taxes on individual income. Over the next decade, the CBO expects federal revenue over GDP to average 18.1 percent and reach 18.3 percent in 2024.

After reaching a peak during the 1980s, federal expenditures over GDP were on a downward trend until the recession hit. Outlays as a percentage of GDP were 18.8 percent in 2001-2007, climbed to 22.1 percent in 2008-2014 and are projected to average 21.5 percent in 2015-2024, climbing to 22.1 percent by 2024. At first glance, the recent increase in spending appears permanent, rather than a temporary response to the economic downturn. However, looking at the composition of expenditures reveals pre-existing trends that dominate the budget outlook.

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Relative to the U.S. economy, defense spending has been on a decline since the end of the Korean War in 1953. This trend has been interrupted by periodic episodes of military conflict and buildup. Regardless, over the past two decades, defense spending over GDP has been persistently below 5 percent. Current projections estimate it will continue falling, averaging 2.9 percent of GDP in 2015-2024.

As a result of the economic stimulus package enacted in the American Recovery and Reinvestment Act of 2009, nondefense discretionary spending increased significantly in 2009-2012, reaching a peak of 4.5 percent of GDP in 2010.[5] Currently, the CBO projects this type of spending to decline steadily as a percentage of GDP over the next decade, to an average of 2.8 percent for 2015-2024, mainly due to the spending caps set by the Budget Control Act of 2011.

In contrast to the declining trends in discretionary spending, mandatory expenditures have been growing consistently.[6] Items in this category include Social Security, Medicare, Medicaid, unemployment insurance and assistance programs. In the wake of the last recession, mandatory spending rose substantially, from an average of 10.1 percent of GDP in 2001-2007 to 12.6 percent of GDP in 2008-2014. A substantial fraction of this increase was due to expansions of Social Security and Medicare. Smaller parts of the increase stemmed from programs like Medicaid and unemployment insurance, although the effects of the latter have been diminishing as the unemployment rate returns to normal. Over the next decade and beyond, mandatory spending as a percentage of GDP is projected to continue growing, mostly due to further expansions of Social Security, Medicare and Medicaid. By 2024, the combined size of Social Security and major health-care expenditures will be almost 12 percent of GDP. Current long-term CBO projections estimate this fraction to surpass 15 percent by 2038.

The remaining spending category is net interest. The steady drop in interest rates since the 1980s implied a declining financial burden of servicing the public debt. In the 2000s, the impact of interest payments on the budget was significantly lower than in the preceding two decades. However, given the rapid accumulation of debt in response to the deficit policies implemented during the last recession and the expected rise in interest rates, interest payments over GDP are projected to increase

The outlook for the next 10 years shows that both revenue and expenditures will reach historically high levels for a period without a major military conflict (of the magnitude of the Civil War, for example, or the two world wars). The added tax burden is expected to fall mostly on income earned by individuals, as opposed to hikes in Social Security contributions or corporate taxes.

Although discretionary spending will continue declining as a fraction of the economy, entitlements will drive total expenditures persistently higher than prerecession levels. Since the growth of spending is expected to outpace the growth in revenue, deficits will continue to pile up, and the public debt will keep on growing. Coupled with an expected increase in interest rates, the burden of servicing the public debt will

**U.S. Federal Budget** *(Percentage of Gross Domestic Product)*

| | Revenues | | | | | Outlays | | | | | | | | Deficit | Debt |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Individual Income | Social Insurance | Corporate Income | Other | TOTAL | Defense | Other Discretionary | Social Security | Major Health Care** | Other Mandatory | Net Interest | TOTAL | | | Held by the Public |
| 1971-1980 | 7.9% | 5.0% | 2.5% | 2.0% | 17.4% | 5.4% | 4.5% | 3.8% | 1.2% | 3.3% | 1.5% | 19.6% | | 2.2% | 25.7% |
| 1981-1990 | 8.1% | 6.2% | 1.6% | 1.7% | 17.6% | 5.6% | 3.8% | 4.4% | 2.0% | 3.0% | 2.8% | 21.6% | | 3.9% | 35.1% |
| 1991-2000 | 8.3% | 6.4% | 1.9% | 1.5% | 18.2% | 3.7% | 3.4% | 4.3% | 3.1% | 2.4% | 2.8% | 19.7% | | 1.5% | 43.8% |
| 2001-2007 | 7.7% | 6.2% | 1.8% | 1.3% | 17.1% | 3.6% | 3.6% | 4.1% | 3.6% | 2.4% | 1.6% | 18.8% | | 1.8% | 34.3% |
| 2008-2014* | 7.2% | 5.8% | 1.5% | 1.4% | 15.8% | 4.2% | 3.8% | 4.7% | 4.7% | 3.3% | 1.4% | 22.1% | | 6.3% | 62.1% |
| 2015-2024* | 9.0% | 5.8% | 2.0% | 1.3% | 18.1% | 2.9% | 2.8% | 5.2% | 5.6% | 2.5% | 2.5% | 21.5% | | 3.3% | 74.4% |

* Fiscal years 2014 to 2024 are projected.

** Includes spending on Medicare (net of offsetting receipts), Medicaid, the Children's Health Insurance Program and subsidies offered through new health insurance exchanges.

SOURCE: Congressional Budget Office.

NOTE: Some totals do not add up to 100 because of rounding.

significantly. The CBO estimates this fraction to go from an average of 1.4 percent in 2008-2014 to 2.5 percent in 2015-2024, climbing to 3.3 percent by 2024. These projections assume nominal interest rates on Treasury bonds will return close to their precrisis levels within the next five years. For example, the annual interest rate on a 10-year Treasury note is expected to increase to 5 percent by 2018, slightly above the 2001-2007 average. However, it is possible that the downward trend in interest rates since the 1980s (due, for example, to financial innovation that made bonds and other liquid assets more perfect substitutes for cash) may imply that interest rates will return to a lower level once the economy fully recovers. Thus, current projections may be overstating the impact of future net interest payments on the deficit.

become a larger component of the budget. How much larger will depend critically on the future evolution of interest rates. Current CBO projections estimate average deficits of 3.3 percent of GDP for 2015-2024, which is almost twice the precrisis 2001-2007 average but about half the 2008-2014 average. Debt in the hands of the public is projected to continue growing as a percentage of GDP, albeit at a much slower pace than during the last recession. By 2024, it will reach close to 80 percent, a figure not seen since 1948, after the end of World War II. Ω

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ENDNOTES

1. As dated by the National Bureau of Economic Research, the last recession lasted from December 2007 until June 2009.
2. These figures refer to "debt held by the public," which excludes holdings by federal agencies (e.g., the Social Security Trust Funds).
3. Projections as of April 2014. The fiscal year in the United States begins Oct. 1 and ends Sept. 30 of the subsequent year and is designated by the year in which it ends. Before 1977, the fiscal year began July 1 and ended June 30.
4. High earners are defined as those earning more than $400,000 a year or $450,000 for those filing joint tax returns.
5. Nondefense discretionary expenditures include spending on national parks, education, social services, transportation, public works, etc.
6. Mandatory expenditures are defined as those determined by laws other than appropriation acts.