Q. What have budget trends been over the short and long term?

A. Federal budget deficits are largely driven by external events—war, recession—in the near term and by demography in the long run. When events conspire to drive revenues above the trend, tax cuts usually bring them down with alacrity.

The budget deficit has been on a roller coaster in recent years because of the Great Recession and the subsequent recovery. (The federal budget deficit measures the amount by which total government outlays exceed total revenues in a given year.) In 2007, before the recession, the deficit had fallen to 1.1 percent of gross domestic product (GDP) despite the Afghan and Iraq wars and significant tax cuts earlier in the decade. Then the recession hit and the deficit soared to 9.8 percent of GDP by 2009, as tax revenues fell, automatic safety net programs kicked in, and hundreds of additional billions were spent to stimulate the economy. But the economic recovery and subsequent economic expansion quickly lowered the deficit again. By 2015 it was 2.4 percent of GDP.

Toward the end of 2017, the Congress passed a major tax cut that was not paid for. Then, in early 2018, they increased previously legislated caps on discretionary spending. This put the deficit on a steep upward trend and by 2020, it is expected to exceed $1 trillion for the first time since the Great Recession. Ultimately, budget projections have it growing to $1.5 trillion by 2028.

SHORT TERM

As the deficit rises above $1 trillion in 2020, The debt-GDP ratio is expected to grow from 77 percent in 2017 to 79 percent in 2020 and, ultimately, to 96 percent in 2028. This will be the highest debt-GDP ratio since shortly after World War II.

All categories of spending will rise. Recent policy changes have not affected mandatory spending significantly and it will continue its upward trend, rising 14 percent between 2017 and 2020. Discretionary spending will rise 12 percent, largely because of the legislated increase in spending caps. The interest bill on the debt will rise 84 percent because of the large increase in the debt and a forecasted increase in interest rates.

Tax revenue will fall as a percentage of GDP. The recent tax cut will lower tax revenue from 17.3 percent of GDP in 2017 to 16.7 percent in 2020. Under constant law, one would normally expect tax revenues to grow faster than GDP because real growth pushes people into higher tax brackets.

Background

What have budget trends been over the short and long term?

LONG TERM

Over the longer run, programs targeting the aged will hasten spending growth as baby boomers enter these programs in large numbers and expected life continues to increase. The main impact will be on spending for Social Security, Medicare, and Medicaid. Those three programs already accounted for over 50 percent of total spending in 2017 and are expected to continue to grow faster than the economy and tax revenues for the foreseeable future. Medicare and Medicaid face the added problem that even if the population were not aging, costs per recipient would be rising faster than incomes per capita after one adjusts for the effects of aging. This so-called excess cost growth slowed surprisingly after 2009. However, the Congressional Budget Office expects the growth of Medicare and Medicaid costs to reaccelerate, although not to the high levels experienced in recent decades.

The ratio of revenues to GDP has been remarkably constant over the past 50 years, almost always varying between 17 and 19 percent of GDP. Whenever the ratio has gone above 19 percent, a significant tax cut has followed. A surtax imposed during the Vietnam War pushed the ratio to 19 percent in 1969, but it was quickly removed. Rapid inflation again pushed the tax burden above 19 percent in 1981, provoking the large Reagan tax cuts. The Bush tax cuts of the early 2000s followed an enormous surge in revenues during the dot-com boom of the late 1990s that also pushed the tax burden above 19 percent.

The Great Recession was devastating to revenues and briefly brought them below 15 percent of GDP. Revenues recovered with the economy but in an unusual move, the government passed a major tax cut in 2017 when revenues were already near their historical lower bound of 17 percent. As a result, revenues are expected to drift slightly below 17 percent for the next few years. Excepting the Great Recession years, revenues only fell below 17 percent in four years between 1959 and 2017.

The inexorable growth of Social Security, Medicare, and Medicaid, combined with the reluctance to raise taxes, has been squeezing other entitlements and discretionary spending. Discretionary spending has been hit hardest, with defense falling from 9.1 percent of GDP at the height of the Vietnam War in 1968 to 3.1 percent in 2017. Nondefense spending has fallen somewhat more erratically to 3.2 percent of GDP in 2017 after reaching a 50-year high of 5.0 percent in 1978. The Congress was clearly reacting to these long-run declines when it significantly raised defense and nondefense discretionary spending in early 2018. It did not, however, pay for the increases with tax increases or other entitlement cuts.

The growth in Social Security and health spending combined with a near constant tax burden leads to the conclusion that the United States is on an unsustainable fiscal path. If these well-entrenched fiscal policies continue, the deficit will persist on an upward trend and the debt will continually grow relative to GDP. As a result, interest on the debt will become a major budget problem. Eventually, the system will explode into a fiscal crisis, and there will be no choice but to undertake painful spending and tax policy changes.

Data Sources

Office of Management and Budget. *Historical Tables*.

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