Some Background

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A. In the long run, federal budget deficits are driven by demography and rising health care costs pushing spending above scheduled revenues. Short-term deficits are typically driven by external events such as war, recession, or, in 2020, pandemic. In recent years, however, persistent, large deficits have also been driven by conscious policy choices. When events drive revenues above trend, tax cuts usually bring them down quickly.

The budget deficit has been on a roller coaster in recent years because of the Great Recession, the subsequent recovery, policy choices, and, most recently, the COVID-19 pandemic. (The federal budget deficit measures the amount by which total government outlays exceed total revenues in a given year.) In 2007, before that recession, the deficit had fallen to 1.1 percent of gross domestic product (GDP) despite the wars in Afghanistan and Iraq 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.

SHORT TERM

Since then, the deficit has grown faster than the economy, reaching 4.6 percent of GDP in 2019. That increase was driven by a combination of tax cuts (e.g., the tax cuts enacted at the end of 2017) and spending increases (e.g., the lifting of discretionary spending caps in early 2018). Before COVID-19 hit, the Congressional Budget Office projected deficits of $1 trillion or more each year in the next decade, reaching 5.4 percent of GDP in 2030.

The economic shock from COVID-19—and the policy response to it—has lifted the budget deficit to levels not seen since World War II. In April 2020, CBO estimated that the deficit would hit $3.7 trillion in 2020, more than 17 percent of GDP. CBO also estimated that the public debt would reach 101 percent of GDP by the end of the year, the highest debt-to-GDP ratio since shortly after World War II.

LONG TERM

Over the longer run, programs helping seniors will hasten spending growth as baby boomers continue to enter these programs and as expected lifespan once again increases. The main impact will be on spending

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for Social Security, Medicare, and Medicaid. Those three programs already account for over 50 percent of total spending in a normal year and are expected to continue to grow faster than the economy and tax revenues for the foreseeable future. Medicare and Medicaid face the added challenge 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 was remarkably consistent over much of the past 50 years, almost always varying between 17 and 19 percent of GDP. Whenever the ratio rose above 19 percent, a significant tax cut 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 were expected to drift slightly below 17 percent for the next few years. The COVID-19 crisis will likely drive them even lower for several years. Excepting the Great Recession years, revenues only fell below 17 percent in four years between 1959 and 2017.

The 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 3.2 percent in 2020. Nondefense spending has fallen somewhat more erratically to 3.1 percent of GDP in 2019 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 cuts in other spending.

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. Low interest rates have helped offset some fiscal pressures from accumulating debt. If interest rates rise, however, interest on the debt could become a major budget problem. Eventually, there may be no choice but to undertake painful spending and tax policy changes.

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Data Sources

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