

CRS Report for Congress

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The Federal Budget Deficit: A Discussion of Recent Trends

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Summary

The federal budget deficit in FY2004 is projected to be 4.2% of gross domestic product (GDP). By that measure, the projected FY2004 deficit would be the seventh largest budget deficit in the last 50 years. When the influence of economic conditions and temporary factors is excluded from the measurement of budget balances, the projected FY2004 deficit would be 3.7% of GDP, the third largest in 50 years.

The projected FY2004 deficit represents a dramatic turnaround from the FY2000 surplus of 2.4% of GDP. Most of this turnaround can be traced to a fall in receipts, from a 50-year high of 20.9% of GDP in FY2000 to a projected 50-year low of 15.8% of GDP in FY2004.

In percentage terms, tax cuts accounted for approximately 52% of the projected decline in the federal budget balance between FY2000 and FY2004. The downturn in the economy was responsible for about 27% of the projected deterioration in federal finances, while increases in federal outlays as a percentage of GDP were responsible for another 21%. This report will not be updated.

Concern over the federal budget deficit has prompted a growing debate in Congress over how the budget turned from surpluses into deficits, and what can be done to restore balance. A review of the historical data on federal receipts, outlays, and deficits can help identify the forces that led to the current situation.

This report addresses two specific issues. First, how do expected FY2004 federal receipts, outlays, and the resultant deficit compare to historical averages? Second, what factors caused the federal budget to change from a surplus in FY2000 to a deficit in FY2004?

Historical Data on Federal Receipts, Outlays, and Budget Balances

Figure 1 shows total federal receipts as a percentage of gross domestic product (GDP) over the FY1955 to FY2004 time period. Budgetary totals as a percentage of GDP provide the best measurement of fiscal balance over long periods of time because they correct for changes in the price level and growth in the economy.

As shown in Figure 1, over the last 50 years federal receipts have averaged about 18.1% of GDP. However, there has been a great deal of fluctuation around the average over time. The largest change as a share of GDP has occurred over the last five years, when receipts fell from a 50-year high of 20.9% of GDP in FY2000 to a projected 50-year low of 15.8% of GDP in FY2004, which would be 2.3 percentage points below the 50-year average. (Standardized receipts are explained on page 3.)

Figure 1. Federal Receipts as a Percentage of GDP, FY1955 - FY2004

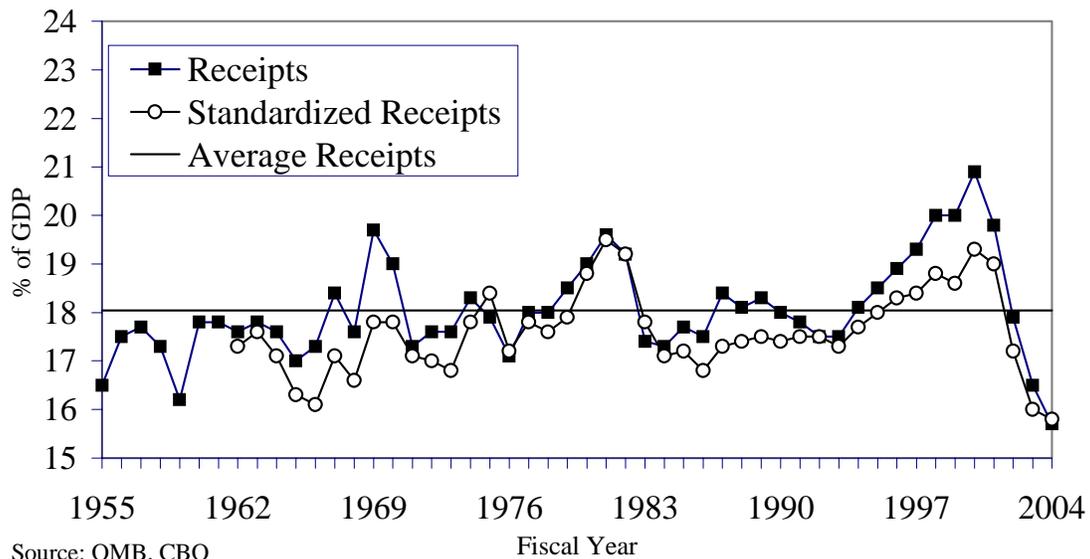
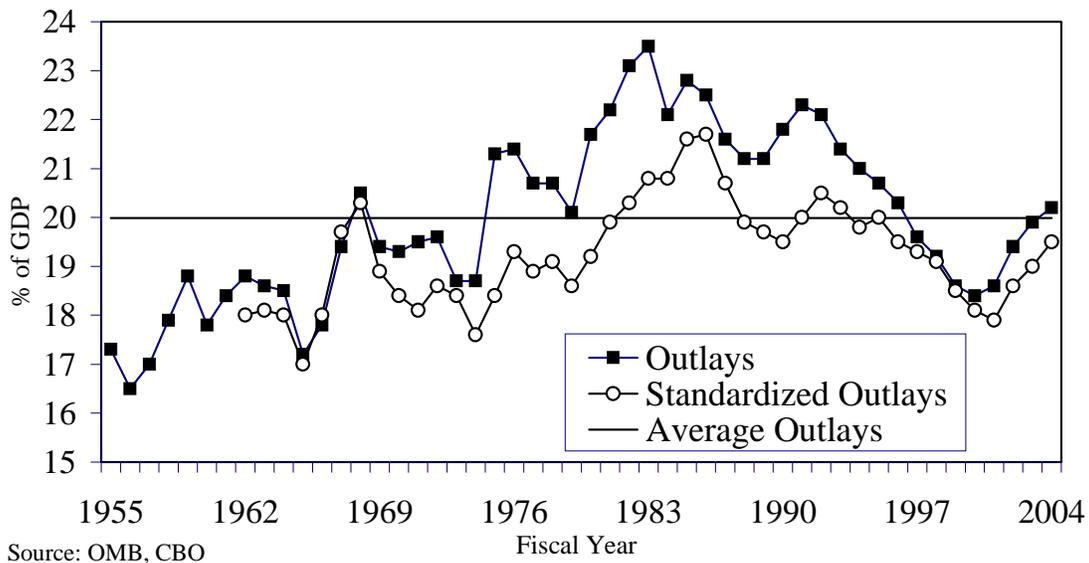


Figure 2 shows total federal outlays as a percentage of GDP. Over the last 50 years, outlays have averaged about 20% of GDP. The figure shows that there was an upward trend in federal outlays as a percentage of GDP between FY1955 and FY1983. Since FY1983, there has generally been a downward trend in outlays as a percentage of GDP. Between FY1992 and FY2000, federal outlays continuously declined as a percentage of GDP, reaching 18.4% of GDP in FY2000. In FY2001, federal outlays as a percentage of GDP began to rise again, and by FY2004 they are projected to reach 20% of GDP, equal to their 50-year average.

As these two figures show, the deterioration in the budget balance since FY2000 is largely the result of falling receipts, not increases in outlays as a percentage of GDP. During this period, receipts fell from 20.9% of GDP to a projected 15.8% of GDP (a decline of 5.1 percentage points), while outlays rose from 18.4% of GDP to a projected 20.0% of GDP (an increase of 1.6 percentage points).

Figure 2. Federal Outlays as a Percentage of GDP, FY1955 - FY2004

This recent trend, with receipts falling as a percentage of GDP and outlays rising as a percentage of GDP, has caused the budget balance to turn from a surplus of 2.4% of GDP in FY2000 to a projected deficit of 4.2% of GDP in FY2004. As can be seen in Figure 3, the projected FY2004 deficit as a percentage of GDP is the seventh largest budget deficit over the last 50 years. The average budget balance over the FY1955 through FY2004 period has been a deficit of 1.9% of GDP. Thus, the projected budget deficit in FY2004 is 2.3 percentage points larger than (or more than double) the 50-year average.

But these data give no indication whether the fall in receipts and rise in spending were policy induced or the result of the economic slowdown. When GDP growth slows, tax receipts tend to fall as the growth in income slows and mandatory spending on certain programs — such as unemployment insurance — automatically rises without any change in policy.

To distinguish the effect of economic and policy changes on the budget, the Congressional Budget Office (CBO) calculates a standardized budget measure that strips out the economic and temporary effects.¹ This is done by estimating what receipts and outlays would be if the economy were at “full employment,” with its labor and capital resources fully employed.² The standardized budget measure makes other adjustments for temporary phenomena such as changes in capital gains realizations, the effects of changes in inflation on interest payments on the national debt, timing changes in federal payments and receipts, and so on.

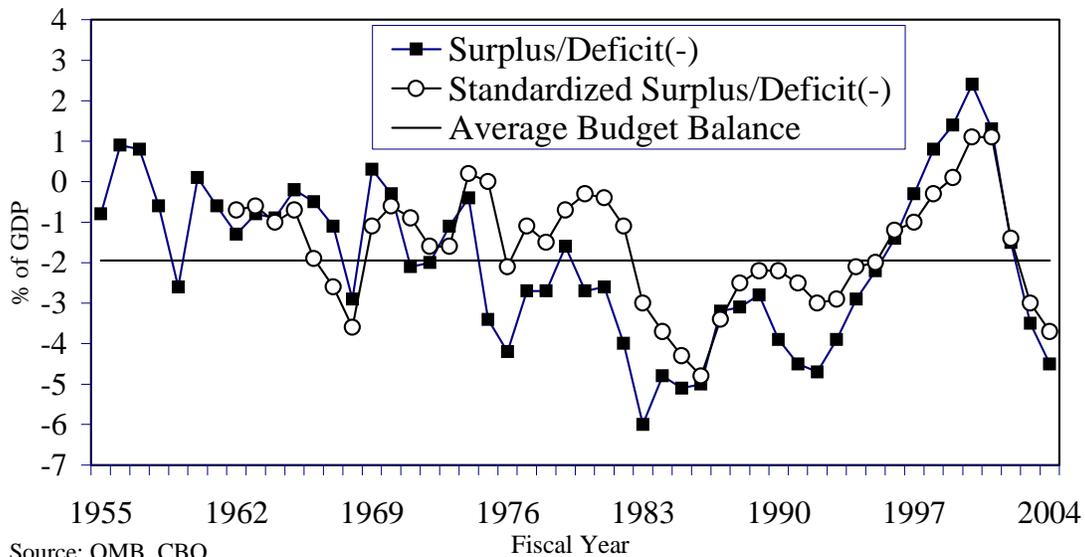
¹ See Congressional Budget Office, *The Cyclically Adjusted and Standardized-Budget Measures*, March 2004.

² For a discussion of the uncertainty of full employment measures see CRS Report RL32274, *A Changing Natural Rate of Unemployment: Policy Issues*, by Marc Labonte.

The previous three figures also show standardized receipts, outlays, and budget balances as a percentage of GDP for the FY1962 to FY2004 period. As the figures illustrate, part of the volatility over time is a result of changing economic conditions and temporary factors rather than policy changes. Standardized receipts and outlays show that annual deviations from the long-run averages that result from policy changes are smaller than the actual data would suggest.

For example, on a standardized basis, the FY2004 budget deficit is 3.7% of GDP, which makes it the third largest standardized deficit in the past 50 years. Hence, the FY2004 standardized budget deficit would still be well above the historical average, even without the effects of a recession.

Figure 3. Federal Surpluses/Deficits as a Percentage of GDP, FY1955 - FY2004



Changes in the Budget Balance, FY2000 to FY2004. Table 1, on the next page, shows the effects of policy changes and economic conditions on receipts, outlays, and the budget balance between FY2000 and FY2004.

If the economy were at full employment and other temporary factors were removed (the standardized estimate), CBO estimates that receipts would equal a projected 15.8% of GDP in 2004 — the same as actual receipts. (Although economic conditions are currently reducing receipts, other temporary factors — notably, over-withholding — are increasing them by a similar amount.) In FY2000, CBO estimates the economy was above full employment — economic output (and therefore tax revenue) was unsustainably high. Standardized receipts were 19.3% of GDP in FY2000, while actual receipts were 20.9% of GDP.

The difference between the decline in actual receipts and standardized receipts represents the effect of the economic downturn and temporary factors on receipts. In this case, actual receipts fell by 5.1 percentage points and standardized receipts fell by 3.5 percentage points. Economic conditions were therefore responsible for about 1.6

percentage points of the total decline in actual receipts (5.1 percentage points less 3.5 percentage points). In percentage terms, this is about 31% of the total decline in receipts.

On the other hand, the change in standardized receipts gives a rough estimate of the effects of policy changes on federal receipts because economic and other temporary factors have been stripped out. Hence, policy changes (tax cuts) reduced federal receipts by 3.5 percentage points of GDP (69% of the total revenue decline) between FY2000 and FY2004.³

Table 1: Actual and Standardized Budget Totals, 2000-2004
(as a % of GDP)

	Actual as a Percentage of GDP		Standardized as a Percentage of GDP		FY2000 to FY2004				
	FY2000	FY2004	FY2000	FY2004	Percentage Point Change			Percentage of Total Change	
					Actual	Due to Policy Changes	Due to Economic Conditions	Due to Policy	Due to Economic Conditions
Revenue	20.9%	15.8%	19.3%	15.8%	-5.1	-3.5	-1.6	69%	31%
Outlays	18.4%	20.0%	18.1%	19.5%	+1.6	+1.4	+0.2	87%	13%
Surplus/Deficit	2.4%	-4.2%	1.1%	-3.7%	-6.6	-4.8	-1.8	73%	27%

Source: CRS calculations based on CBO data.

The decline in standardized receipts is significantly larger than the “scoring” of legislative changes to the tax code by the Joint Tax Committee (JCT) and CBO at the time the tax cuts were enacted. It was estimated that the three tax cuts enacted between 2001-2003 (P.L. 107-16, P.L. 107-147, and P.L. 108-27) would cost about \$265 billion or 2.3% of GDP in 2004, compared to the 3.5% of GDP decline in standardized receipts from 2000 to 2004 forecast by CBO.

Unlike the revenue side, there is no straightforward way to make a comparison of policy changes affecting outlays over time because spending levels for discretionary programs are determined by annual appropriations. A number of different measurements of outlays could be considered to be “current policy,” including keeping spending

³ There is a third potential cause of changes in revenue over time. Holding the tax code and the business cycle constant, the same tax code will yield a different amount of revenue at different times because of changes in the composition of GDP. For example, if a greater proportion of GDP is devoted to preferentially taxed activities (e.g., fringe benefits vs. wages) over time, the same tax code will yield less revenue. This factor should be unimportant over short periods of time. In fact, there are factors at work that would lead the same tax code to yield more revenue over time. Because of “real bracket creep,” rising income leads to higher average effective tax rates with the same statutory rates. Relatively faster income growth among high income cohorts also leads to higher average effective tax rates with the same statutory rates. And because some parts of the tax system are not inflation adjusted, notably the alternative minimum tax, nominal changes in income lead to higher real taxes.

constant, increasing spending at the rate of inflation, or increasing spending at the rate of population growth. In this report, keeping spending constant as a percentage of GDP is used to make comparisons over time. Using any of the other measures would attribute a greater proportion of the change in fiscal policy to spending. As can be seen in Figure 2, spending as a percentage of GDP shows no clear upward or downward trend over the entire 50-year period, and that measure would therefore have made a better projection of policy in the long term than the other three measures, which would have consistently under-predicted spending levels.

Between FY2000 and FY2004, actual outlays increased from 18.4% to 20.0% of GDP, a change of 1.6 percentage points. Policy effects (changes in standardized budget outlays) accounted for 1.4 percentage points (87%) of the total increase in outlays. Subtracting changes in standardized outlays from changes in actual outlays shows that 0.2 percentage points (13%) of the increase was due to the economy and other temporary factors.⁴

Combining outlays and receipts, the actual budget balance changed from a surplus of 2.4% of GDP in FY2000 to a projected deficit of 4.2% in FY2004, a change of 6.6 percentage points. The standardized budget changed from a surplus of 1.1% of GDP in FY2000 to a projected deficit of 3.7% in FY2004, a change of 4.8 percentage points. Subtracting changes in standardized budget balances from changes in actual budget balances shows that 1.8 percentage points (27%) of the deterioration in the budget balance was due to the economy and other factors. Thus, policy changes, primarily tax cuts, were responsible for 73% the deterioration in the budget balance since FY2000. Tax cuts accounted for 52% (3.5 percentage points) and the increase in outlays accounted for 21% (1.4 percentage points) of the overall deterioration.⁵

These figures overstate the contribution of outlay changes to increases in the deficit because policy changes that increase the deficit increase the interest payments on the debt, which are counted as an increase in outlays, whether the policy change affects receipts or outlays. The recent series of tax cuts accounts for about two-thirds of the increase in interest payments caused by policy changes.

⁴ In the case of mandatory spending, not all increases in spending are a result of policy changes. Some changes are the result of changes in eligibility among recipients (e.g., more retirees eligible for Social Security benefits). The standardized increase in mandatory spending between FY2000 and FY2004 was 0.6 percentage points of GDP. Since legislative changes to mandatory programs since 2000 have been estimated to cost 0.5% of GDP in 2004, it appears that most of the change in mandatory spending is due to legislation, not eligibility changes.

⁵ It is possible that policy changes between FY2000 and FY2004 caused economic growth and other macroeconomic variables to differ from what they would have been in the absence of policy changes. This report does not attempt to measure that effect.