Reducing the Budget Deficit: Policy Issues

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Summary

In 2009, the federal budget deficit (the difference between outlays and revenues) exceeded $1 trillion for the first time, and it has remained above $1 trillion since. Those years also marked the largest the deficit has been as a share of gross domestic product (GDP) in the period since World War II. The budget is not projected to be on a sustainable path under current policy, in the sense that it leads the publicly held debt to continuously grow more quickly than GDP. The timing of deficit reduction remains a difficult issue because of continued weakness in the economy. If deficits are reduced too quickly, the economy might tip back into recession. If unsustainable deficits persist for too long in the economic recovery, it could crowd out private investment and, in the worst case scenario, investors could refuse to continue to finance deficits that they believed were unsustainable.

As one example of the policy changes that would return the budget to a sustainable path, the Congressional Research Service (CRS) estimates that stabilizing debt as a share of GDP at its 2011 level would require budget deficits averaging 2.8% of GDP over the next 10 years. In dollar terms, the deficit could equal $200 billion in 2013, rising to more than $600 billion from 2015 on. Under the Congressional Budget Office's (CBO's) current law baseline, the deficit is already on a sustainable path. Under CBO's Alternative Fiscal Scenario, which modifies the current law baseline by assuming that expiring tax provisions and the "doc fix" to Medicare are extended and that the future automatic spending cuts under the Budget Control Act (BCA) do not come into effect, the deficit would decline from more than 9% of GDP in 2011 to 5% of GDP in 2015, then rise to 6% of GDP by 2022. To reduce the deficit to sustainable levels under this scenario would require some combination of spending cuts and tax increases equivalent to roughly $800 billion in 2013, falling to $275 billion in 2015, then rising to $900 billion by 2022.

The recent growth in deficits is the result of spending reaching its highest level as a share of GDP since 1945 and revenues reaching their lowest level as a share of GDP since 1950. Revenues were low because of the recession and because of the temporary extension of expiring tax provisions, such as the "alternative minimum tax (AMT) patch" and "Bush tax cuts." If these tax cuts are extended again, revenues are estimated to be reduced by about 2.5% of GDP from 2014 on and will remain around their historical average from 2015 on.

Thus far, policy changes to reduce the deficit have targeted mainly discretionary spending. The BCA would reduce discretionary spending by $1.5 trillion and mandatory spending by less than $0.2 trillion over 10 years if automatic cuts are allowed to begin in 2013. Including interest savings, the BCA would reduce the deficit by about 1% of GDP from 2014 on. Even if these cuts proceed as scheduled, overall spending is projected to rise and remain above its historical average over the next 10 years because of the growth in mandatory spending. Defense, Social Security, and Medicare account for more than half of total spending. Outside of those three programs and net interest, all other spending is about three-quarters the size of the budget deficit in 2012.

Growth in entitlement spending on the elderly drives long-term projections of large budget deficits—by mid-century, outlays on Social Security and health programs would exceed total revenues. Most proposals to reform entitlement programs for the elderly would generate significant budgetary savings in the long run, but little budgetary savings in the short run, partly because most proposals exempt current retirees from reform and partly because the savings from these changes would compound over time. The U.S. fiscal outlook is not a purely long-term issue, however—deficits are already at unsustainably high levels today.

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The federal budget has been in deficit (i.e., spending has exceeded revenues) since 2002, and deficits became significantly larger in 2009. That year, the deficit topped $1 trillion for the first time ever, and it is projected to remain above $1 trillion in 2012 for the fourth year in a row.[1] Relative to the overall size of the economy, budget deficits from 2009 to 2011 have been significantly larger than in any other year since World War II.

From 1946 to 2008, budget deficits averaged 1.7% of gross domestic product (GDP) and exceeded 5% of GDP only three times (equaling 7.2% in 1946, 6.0% in 1983, and 5.1% of GDP in 1985). From 2009 to 2011, the budget deficit averaged 9.3% of GDP, and it is projected to equal 7% of GDP in 2012.[2] Current deficits are larger as a share of GDP than any recorded historically except for those recorded during the Civil War, World War I, and World War II. In the past, deficits have proven sustainable because periods of moderate growth in the debt relative to GDP have been followed by periods when debt fell relative to GDP. Under current policy, deficits are projected to cause the federal debt to continuously grow faster than national income, which is unsustainable. The federal debt held by the public has grown from 40% of GDP in 2008 to a projected 73% of GDP in 2012.

Congress has expressed interest in examining policy options to reduce the deficit. The Congressional Research Service (CRS) does not take a position on the best way to reduce the deficit. This report organizes and presents information to help policymakers frame the debate. This report first discusses the size of projected budget deficits, then discusses how much the deficit would need to be reduced to return to long-term sustainability, then analyzes alternative time frames for reducing the deficit, and finally discusses broad policy choices for reducing the deficit. For an overview of the causes and consequences of the long-term fiscal outlook, see CRS Report RL32747, *The Economic Implications of the Long-Term Federal Budget Outlook*, by Marc Labonte.

What Policy Changes Have Been Taken to Reduce the Deficit so Far?

From FY2001 to FY2010, policy changes added to budget deficits each year.[3] In FY2011, policy changes were a mix of deficit-reducing legislation and deficit-increasing legislation. To date,

[1] All budget data presented in this report are from Congressional Budget Office, *Preliminary Analysis of the President's Budget for FY2012,* March 2011 and Congressional Budget Office, Budget and Economic Outlook, January 2012 (hereafter referred to as "CBO baseline"), or Office of Management and Budget, *FY2013 Budget of the U.S. Government*, February 2012 (hereafter referred to as "President's Budget"). The budget deficit is the excess of outlays over revenues in a given year, broadly similar to the amount borrowed from the public that year. The publicly held debt is the accumulation of all past borrowing from the public. The gross debt is the publicly held debt and the intragovernmental debt (the debt that one part of the federal government borrows from another part, mainly government trust funds). All references to years are to fiscal years, unless otherwise noted. For background information on the debt and deficit, see CRS Report WKS0001_Overview, *Federal Debt and Deficit: Key Sources*, by Justin Murray.

[2] Expressing budget data as a percentage of GDP is most appropriate for making comparisons over extended periods of time because it allows the relative size of those amounts to be consistently compared. Dollar figures are not appropriate because of inflation, which means that a dollar has a smaller amount of purchasing power over time, and because as the economy has become larger, there are more resources available to finance spending through borrowing or taxes.

[3] For information on causes of the budget deficit, see CRS Report R41134, *The Impact of Major Legislation on Budget Deficits: 2001 to 2010*, by Marc Labonte and Margot L. Crandall-Hollick.

recent policy steps to reduce the deficit have primarily focused on reducing discretionary spending (i.e., spending that is provided and controlled through the appropriations process). Discretionary outlays declined from $1.347 trillion in 2010 and $1.346 trillion in 2011 to a projected $1.308 trillion in 2012. Part of that decline is caused by a decline in spending on overseas contingency operations (OCO), but most is the result of a decline in non-defense discretionary spending. Because inflation reduces the purchasing power of $1 over time, the decline is larger in real terms. Relative to the January 2011 baseline level, which adjusts for inflation, discretionary spending was reduced by $29 billion in 2011.[4]

The reduction in 2011 discretionary spending occurred through the 2011 appropriations process. For 2012 to 2021, the Budget Control Act (P.L. 112-25) reduced discretionary spending and mandatory spending were reduced relative to the baseline.[5] The Budget Control Act cut spending through a two-step process.[6] In the first step, student loan programs were cut and statutory caps were set for discretionary spending for 2012 to 2021, with OCO, disaster spending, and emergency spending exempt from the caps. In the second round (often referred to as the "trigger"), additional spending cuts will be implemented beginning in January 2013. Most of these round two spending cuts will fall on discretionary spending, through sequestration (the across-the-board cancellation of budgetary resources) in 2013 and a reduction to the statutory discretionary caps for 2014 to 2021. Most mandatory programs are exempted from the act's cuts, but a few smaller programs and parts of Medicare that are not will be cut through a sequestration from 2013 to 2021. The cut to Medicare is capped at 2%.

Relative to 2011 levels adjusted for inflation, CBO projects that the Budget Control Act reduces defense discretionary spending by $15 billion in 2012 and $812 billion over 10 years and non-defense discretionary spending by $12 billion in 2012 and $714 billion over 10 years.[7] These estimates require some assumption to be made about the levels of discretionary spending that will occur in categories that are exempt from the caps. For example, CBO assumes that emergency spending, which is exempted from the caps and designated by Congress and the President, will be zero in the next 10 years; if emergency spending does take place, discretionary savings from the Budget Control Act would be reduced dollar for dollar. In addition, the Budget Control Act cuts mandatory spending on student loan programs by $5 billion over 10 years and cuts other mandatory spending (mostly Medicare) through the second-round sequester by $165 billion over 9 years.[8] Since lower outlays would result in a lower debt relative to the baseline, debt service savings from these spending cuts would reduce the deficit by roughly another $300 billion over 10 years. Including these interest savings, the Budget Control Act reduces the annual deficit by about 1% of GDP from 2014 on.

[4] Although the FY2011 had already begun, appropriations had not been completed when the January baseline was released.

[5] For more information, see CRS Report R42013, *The Budget Control Act of 2011: Effects on Spending Levels and the Budget Deficit*, by Marc Labonte and Mindy R. Levit. All of the reductions in spending discussed here would lead to additional declines in spending on net interest because the federal debt would be lower than in the baseline.

[6] For more information, see CRS Report R41965, *The Budget Control Act of 2011*, by Bill Heniff Jr., Elizabeth Rybicki, and Shannon M. Mahan.

[7] Congressional Budget Office, *Testimony Before the Joint Select Committee on Deficit Reduction*, U.S. Congress, October 26, 2011. The amount of savings garnered by the Budget Control Act depends on what baseline it is being compared with. For example, if it were being compared with a baseline based on 2010 levels of discretionary spending, the savings would be higher than if it were compared with 2010 levels.

[8] Congressional Budget Office, *Budget and Economic Outlook*, January 2012, p. 13.

If Congress acts to prevent the second round of spending cuts from taking place beginning in January 2013, but leaves the first round discretionary caps in place, total discretionary spending would be reduced by $778 billion over 10 years. In this scenario, mandatory spending would be cut by only $5 billion, with the cuts falling on student loan programs.

Although spending has been cut, other policy goals, such as stimulating the economy, have also led to recent policy changes that have increased the deficit relative to the baseline. For example, CBO estimates that the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) increased the deficit by $374 billion in 2011, of which $204 billion is attributable to the extension of expiring tax provisions. This act extended the "Bush tax cuts"[9] for two years, extended the alternative minimum tax (AMT) "patch" for one year,[10] extended and expanded unemployment benefits for one year, and implemented a one year payroll tax cut. The 112th Congress has debated whether each of these provisions should be allowed to expire as scheduled or extended further and whether further extensions should be deficit-financed or offset by spending cuts or other tax increases.

How Large Are Projected Deficits Under Current Policy?

Absent policy changes, budget deficits would change over time because spending and revenue levels automatically change over time. Baseline budget projections are used to provide a benchmark against which budgetary decisions can be made and policy proposals can be compared over the budget window. A baseline is not meant to be the best guess of future outcomes or the most desirable outcome, but a reasonable starting point for comparing policy options. The projected magnitude and path of budget deficits depends greatly on what baseline assumptions are made.

CBO estimates an official 10-year *current law* baseline, which assumes that certain provisions of law will expire as scheduled, even though many of these provisions have routinely been extended in the past.[11] Examples of such provisions include the 2001 and 2003 tax cuts (popularly known as the "Bush tax cuts"), which were extended until the end of 2012 to avoid their expiration at the end of 2010, and the "alternative minimum tax (AMT) patch," which has been repeatedly extended, most recently until the end of 2011. Another example is the Medicare cuts required in law by the sustainable growth physician payment formula; Congress has enacted legislative

[9] The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27) are popularly referred to as the "Bush tax cuts." Various acts since then have sped up the implementation or prevented the expiration of certain provisions of those acts.

[10] The alternative minimum tax is not adjusted for inflation. As a result, Congress has enacted a series of temporary "patches" to prevent a spike in taxpayers subject to the AMT. See CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

[11] Some expiring mandatory spending programs are assumed to continue under the baseline. According to CBO, "The Deficit Control Act specifies some exceptions. For example, spending programs whose authorizations are set to expire are assumed to continue if they have outlays of more than $50 million in the current year and were established at the time of or before the enactment of the Balanced Budget Act of 1997. Programs established after that law was enacted are not automatically assumed to continue but are considered individually in consultation with the budget committees." Congressional Budget Office, *Budget and Economic Outlook*, January 2012, p. 11. For a list of programs that CBO assumes will expire in its baseline, see Congressional Budget Office, *Budget and Economic Outlook*, January 2012, Table 3.3.

overrides to prevent those cuts (popularly known as the "doc fix") each year since 2003.[12] CBO's current law baseline also assumes that the second round of spending cuts under the Budget Control Act will occur in 2013 as scheduled. Under the current law baseline, the deficit would decline to about 1% of GDP by 2017, mostly due to the baseline assumptions that the Bush tax cuts and AMT patch will be allowed to expire as scheduled.

CBO also presents an unofficial Alternative Fiscal Scenario, which is a *current policy* baseline that assumes that spending and revenue policies in place now would remain in place. The Alternative Fiscal Scenario modifies the current law baseline by assuming that the doc fix[13] and all expiring tax provisions are extended (including the Bush tax cuts and the AMT patch, as well as dozens of smaller "extenders," with the exception of the payroll tax cut). It also assumes that the second round spending cuts in the Budget Control Act "trigger" will not come into effect in 2013 as scheduled, although it assumes that the first round discretionary caps will remain in place. It yields much larger budget deficits, because the policy changes raise outlays or lower revenues and because the larger budget deficits increase the interest that must be paid on the national debt.

Table 1 illustrates deficit projections under various scenarios, starting with the current law baseline and ending with the Alternative Fiscal Scenario. Under the Alternative Fiscal Scenario, the deficit would bottom out at 5.1% of GDP in 2015. It would then begin to rise again, and reach 6.1% of GDP by the end of the projection window. From 2017 on, the deficit under the Alternative Fiscal Scenario is more than four times larger than the current law baseline relative to GDP. The extension of the Bush tax cuts and AMT patch adds $5.4 trillion to the deficit over 10 years, more than the effects of all of the other assumptions made in the Alternative Fiscal Scenario combined.[14]

[12] For more information, see CRS Report R40907, *Medicare Physician Payment Updates and the Sustainable Growth Rate (SGR) System*, by Jim Hahn and Janemarie Mulvey.

[13] The doc fix is the only expiring mandatory provision that CBO assumes will be continued in its Alternative Fiscal Scenario that is not also included in the current law baseline.

[14] The budgetary effects of extending the AMT patch and Bush tax cuts cannot be separated because of an interactive effect that makes the cost of jointly extending them greater than the cost of extending them separately.

Table 1. Deficit Projections Under Alternative Assumptions

	Fiscal Year										
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
	billions of dollars										
CBO Current Law Baseline	$1,079	$585	**$345**	$269	$302	$220	$196	$258	$280	$279	$339
Baseline + "Doc Fix"	$1,088	$604	$366	$293	$330	$252	$233	$301	$330	$334	$401
Baseline + "Doc Fix" + Extenders	$1,100	$683	$483	$399	$427	$346	$328	$398	$432	$443	$518
Baseline + "Doc Fix" + Extenders + Extend "Bush Tax Cuts" and "AMT Patch"	$1,111	$916	$822	$794	$869	$841	$880	$1,014	$1,117	$1,201	$1,357
CBO Alternative Fiscal Scenario	$1,111	$981	$917	$899	$981	$960	$1,005	$1,144	$1,253	$1,344	$1,495
	% of GDP										
CBO Current Law Baseline	7.0%	3.7%	2.1%	1.5%	1.6%	1.1%	0.9%	1.2%	1.2%	1.2%	1.4%
Baseline + "Doc Fix"	7.0%	3.8%	2.2%	1.7%	1.8%	1.3%	1.1%	1.4%	1.5%	1.4%	1.6%
Baseline + "Doc Fix" + Extenders	7.1%	4.3%	2.9%	2.3%	2.3%	1.8%	1.6%	1.8%	1.9%	1.9%	2.1%
Baseline + "Doc Fix" + Extenders + Extend "Bush Tax Cuts" and "AMT Patch"	7.2%	5.8%	5.0%	4.5%	4.6%	4.3%	4.3%	4.7%	4.9%	5.1%	5.5%
CBO Alternative Fiscal Scenario	7.2%	6.2%	5.5%	5.1%	5.2%	4.9%	4.9%	5.3%	5.5%	5.7%	6.1%

Source: CRS calculations based on CBO data.

Notes: Cost of alternative policy assumptions includes additional debt service generated by those assumptions. CBO Alternative Fiscal Scenario = Baseline + "Doc Fix" + Extenders + Extend "Bush Tax Cuts" and "AMT Patch" + BCA Trigger. See text for details.

Discretionary spending poses conceptual problems for baseline projections. Baseline projections are attempting to extrapolate current policy, not predict the most likely outcome. Because it is determined on an annual basis, there is more than one reasonable assumption of what could be considered an extension of "current policy" into the future. In its baseline projection, CBO assumes that discretionary spending will match the levels set by the Budget Control Act. But the Budget Control Act only sets certain types of discretionary spending in statute; it sets no limit on overseas contingency operations (OCO) or any emergency spending, as designated by Congress and the President. In the baseline, CBO assumes that OCO spending will increase at the rate of inflation and emergency spending will be zero.[15] Altering those assumptions would result in

[15] Baseline spending levels for disasters and overseas military operations can be sensitive to the timing of appropriations acts. From the perspective of crafting a deficit reduction proposal, if one believes that a policy included in the baseline is unrealistic, such as a reduction in overseas contingency operations or the omission of future spending in response to an unforeseen emergency in the next 10 years, it can be included in a budget proposal rather than altering the baseline. The adjusted baseline in the President's budget includes a placeholder for future disasters equal to $80 (continued...)

higher or lower projections of baseline spending under current law. Prior to enactment of the Budget Control Act, CBO assumed that discretionary spending would increase at the rate of inflation (i.e., would stay constant in real terms)—an assumption that was lower than historical growth rates. Under this assumption, deficits would be nearly one percentage point of GDP larger by the end of the 10-year budget window.

Budget projections are subject to a high degree of uncertainty—based on history, actual outcomes are likely to be much better or worse than projections. OMB estimates that the absolute average errors for its budget deficit projections are 1.5% of GDP for the next budget year and 3.5% of GDP for five years in the future.[16] This implies that maintaining the status quo (under the "current policy" baseline) could lead to a successful return to sustainability in five years, or to sustainability problems that are more serious than current projections would suggest.

Why Are Deficits Projected to Decline?

As **Table 1** illustrates, much of the projected reduction in the deficit over the next 10 years is a function of the assumptions made by the current law baseline. But even the Alternative Fiscal Scenario projects that the deficit will fall from over 9% of GDP in 2009-2011 to 7% of GDP in 2012 to as low as 4.9% of GDP in 2017. The deficit declines under the Alternative Fiscal Scenario for the following reasons:

- CBO projects that revenues automatically rise and certain mandatory spending automatically falls as the economy eventually returns to full employment. Economists refer to these changes as "automatic stabilizers." Assuming all expiring tax provisions are extended, revenues are projected to rise from about 15% of GDP in 2011 to 18% of GDP from 2017 on.[17] By 2015, unemployment compensation is projected to fall to less than half of its 2011 level in nominal dollars, although this is partly due to the expected expiration of the temporary extension of benefits.
- The temporary spike in budget authority caused by the American Reinvestment and Recovery Act (ARRA, P.L. 111-5, popularly known as the 2009 "Economic Stimulus Act") has dissipated. ARRA was intended to be only a temporary boost to spending to stimulate the economy, and Congress has allowed budget authority to return to close to pre-ARRA levels to date.[18]
- Most financial stabilization outlays in the federal budget occurred within the Troubled Asset Relief Program (TARP)[19] or on transfers to the government sponsored enterprises (GSEs). CBO projects that there will be only minimal

(...continued)

billion over 10 years.

[16] Office of Management and Budget, *FY2012 Budget of the U.S. Government, Analytical Perspectives*, February 2011, p. 471.

[17] Revenues also rise relative to GDP automatically over time because of "real bracket creep," meaning that the same tax system yields more revenue as national income rises.

[18] In 2008, before ARRA was enacted, non-defense discretionary budget authority was $494 billion. In 2009, it was $803 billion, but in 2011, it was $511 billion.

[19] TARP was created by the Emergency Economic Stabilization Act (P.L. 110-343).

outlays on financial stabilization programs going forward, due to improvements in financial markets and the expiration in 2010 of Treasury authority to enter into new contracts with regards to TARP and the GSEs. In 2009, outlays of $243 billion were recorded for TARP and the GSEs. In 2010 and 2011, transfers to the GSEs declined and, due to budgetary conventions, TARP recorded negative outlays that reduced the deficit.[20]

- CBO assumes in the Alternative Fiscal Scenario that discretionary spending will adhere to the first round discretionary caps created by the Budget Control Act. This would reduce discretionary spending from 9% of GDP in 2011 to 6% of GDP in 2022, which would be its lowest level since data were first collected in 1962.

The projected decline in deficits is temporary, under any scenario in **Table 1**, and is followed by a gradual, long-term increase in the projected deficit. Long-term projections indicate that budget deficits would eventually become very large relative to GDP outside the projection window under current policy if revenues remain similar to their historical share of GDP. Under a long-term projection of current policy, CBO projects deficits would exceed 10% of GDP by 2026 and 20% of GDP by 2043.[21]

How Much Deficit Reduction Is Necessary?

The targeted amount of deficit reduction depends on the policy goal. A balanced budget could be pursued so that the government would have a neutral effect on the national saving rate (by accounting identity, budget deficits reduce the national saving rate).[22] Since the United States has a low national saving rate relative to other countries and relative to domestic investment needs, a case could be made that the government should at least not continue to reduce the national saving rate by running budget deficits in the future. If the policy goal were for the government to increase the national saving rate or reduce the federal debt, then the government could target a budget surplus. Some economists call for a balanced structural budget, which would allow for modest deficits in downturns and budget surpluses in boom times. For 2009 to 2011, a structurally balanced budget would have allowed for an actual deficit of about 2¼% of GDP.[23]

A less ambitious policy goal would be to return fiscal policy to a sustainable path. History demonstrates that budget deficits can be sustained indefinitely as long as they are small enough that government debt does not continuously grow more quickly than GDP. The budget is not projected to be on a sustainable path under current policy (as defined by the Alternative Fiscal Scenario) because the debt held by the public would continuously grow more quickly than GDP, reaching 94% of GDP in 2022, thus implying that an ever-growing portion of national income would be needed to meet interest payments. As long as investors remain willing to finance large

[20] Reductions in TARP's projected lifetime cost led to negative outlays in 2010 and 2011 to compensate for what proved in hindsight to be too large an estimate of its cost in 2009.

[21] Long-term budget data can be found in Congressional Budget Office, *The Long-Term Budget Outlook*, June 2011. The figures cited here are under CBO's "alternative fiscal scenario." For more information, see CRS Report RL32747, *The Economic Implications of the Long-Term Federal Budget Outlook*, by Marc Labonte.

[22] In simple terms, saving is measured by the excess of income over spending. When the government's outlays exceed its revenues, it must borrow from the public to finance the difference, and it has a negative saving rate.

[23] Congressional Budget Office, *The Budget and Economic Outlook*, January 2012, Table C-2.

deficits, there is no barrier to the debt continuing to grow relative to GDP, and there has been no difficulty in financing it to date. At some point, however, investors would refuse to continue to finance such deficits, because the proportion of national income devoted to interest payments cannot rise indefinitely.[24]

The size of the deficit compatible with sustainability depends on the size of the debt at the time it is stabilized and projected GDP growth rates. Because it is unknown how much longer the debt can be increased relative to GDP, for illustrative purposes, CRS estimates the budget deficits that would be consistent with stabilizing debt as a share of GDP at its projected 2012 level (73% of GDP) based on CBO's projections of GDP growth. Stabilizing the debt at 2012 levels would require annual budget deficits no larger than approximately 1% of GDP in 2013, rising to 3.5% of GDP in 2015 and 2016, falling to 2.75% of GDP from 2019 on.[25] In dollar terms, this would amount to a deficit of about $175 billion in 2013, rising to the $600 billion range from 2015 on. If actual policy followed the current law baseline, the budget deficit is already projected to be on a sustainable path. Compared with the Alternative Fiscal Scenario in **Table 1**, achieving sustainability would require some combination of spending cuts and tax increases equivalent to roughly $800 billion in 2013, falling to $275 billion in 2015, and rising each year thereafter until it exceeds $900 billion by 2022. In other words, one possible path to fiscal sustainability is to allow the policy changes already scheduled in law to occur. Another possible path is to prevent those changes from occurring, and then make offsetting cuts in spending or increases in taxes of $800 billion in 2013. CRS makes no recommendations on the best set of policies to achieve sustainability.

Under CBO's Alternative Fiscal Scenario and current interest rate projections, net interest on the federal debt is larger than the sustainable budget deficit, meaning that revenues would need to exceed non-interest spending (what economists call a "primary surplus") to stabilize the debt relative to GDP. Were GDP growth lower or interest rates higher than projected, the primary surplus would have to be larger to be sustainable, and vice versa. By historical standards, CBO's projections of economic growth over the next 10 years are relatively modest, but this is mostly because CBO projects that the labor supply will grow much more slowly than it has historically due to the aging of the population. Projections assume that interest rates will remain at relatively low levels by historical standards over the next 10 years. CBO estimates that if interest rates rose to their average level from 1991 to 2000, the budget deficit would be an average of $100 billion higher per year over the next 10 years. If interest rates rose to their average level from 1981 to 1990, the budget deficit would be an average of $500 billion higher per year over the next 10 years.[26]

Because deficits are projected to continue to grow in the long run, growing cuts in spending or increases in taxes would be required over time to maintain sustainability. Larger cuts in spending or increases in taxes would be required today to spread those changes evenly over time. For example, CBO projects that spending would need to be cut or revenues increased by 8.3% of

[24] Economic effects of an unsustainable budget deficit are discussed in CRS Report R40770, *The Sustainability of the Federal Budget Deficit: Market Confidence and Economic Effects*, by Marc Labonte.

[25] The sustainable deficit is significantly smaller in 2013 than later years because CBO projects low nominal GDP growth in 2013.

[26] Congressional Budget Office, *Letter to the Honorable Paul Ryan*, February 24, 2011, Table 2.

GDP immediately to stabilize the debt-to-GDP ratio over the next 75 years, which would result in a projected budget surplus in 2012.[27]

The U.S. fiscal outlook is not a purely long-term issue, however—deficits are already at unsustainably high levels today, and while projected deficits are larger than today's deficits outside the 10-year budget window, they are also more uncertain. The deficit is a long-term issue in that the economic consequences from running large deficits have been minor to date, but there is the risk that that the deficit's effect on the economy could become negative, possibly acutely so, at any time. Deficits are also a long-term issue in the sense that most observers believe fundamental reforms to outlays and revenues would be necessary to put the budget on a sustainable path; however, any delay to implementing those changes increases the eventual budgetary cost of returning to a sustainable fiscal path, all else equal.

How Quickly Should the Deficit Be Reduced?

The state of the economy is an important factor to consider in determining the desired timing of deficit reduction. All else equal, mainstream economic theory predicts that reducing the deficit would have a contractionary effect on the economy in the short run, whether it be through tax increases or spending reductions. During a period of robust economic growth, that contractionary effect would be more easily absorbed by other sectors of the economy, and the expansion would likely be sustained. During a period of high unemployment, such as the present, reducing the budget deficit would be expected to make unemployment higher (or fall more slowly) than would otherwise be the case, all else equal. On these grounds, an argument could be made for postponing deficit reduction until the economy improves. Given that the effect on the economy is proportional to the size of the deficit reduction, avoiding unwanted contractionary effects also argues for a gradual approach to deficit reduction.

On the other hand, the risk of a fiscal crisis as long as the deficit is at an unsustainable level would argue for moving to sustainability as quickly as possible to eliminate that risk. Low interest rates indicate that markets believe there is little risk of a crisis currently, but market sentiment can change quickly, as has occurred in countries such as Greece and Ireland. In these countries, GDP has contracted deeply and unemployment has risen sharply.

CBO projects that unemployment will rise to 9% in 2013 and 2014. These economic projections are based on the CBO "current law" baseline deficit, which is reduced rapidly between 2012 and 2013. Under the Alternative Fiscal Scenario, which projects a more gradual reduction in the deficit, CBO projects that unemployment would be between 7.4% and 8.9% in 2013. Nevertheless, CBO projects that significant deficit reduction under the current law baseline would not prevent the eventual return to full employment by 2017.

Policy Options for Deficit Reduction

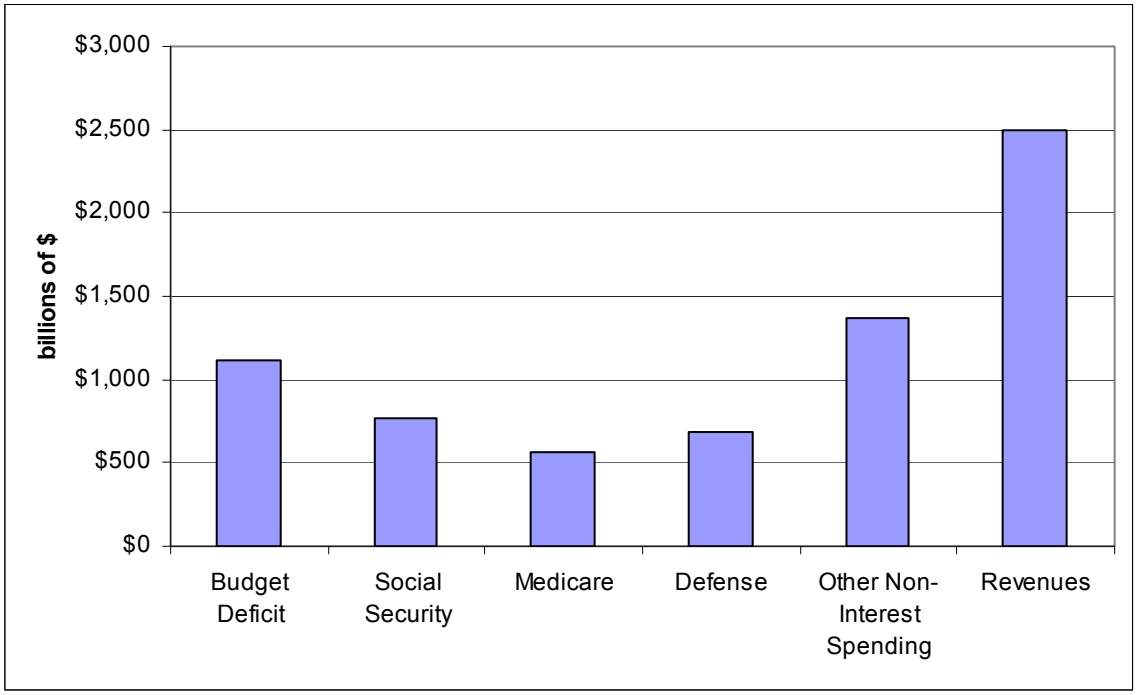
Budget deficits can be reduced through cuts in spending, higher taxes, or a combination of both. Plans to reduce the deficit are faced with the fact that Social Security, Medicare, and defense

[27] Congressional Budget Office, *The Long-Term Budget Outlook*, June 2011, p. 15. Economists call this concept the "fiscal gap."

make up more than half of total spending. **Figure 1** compares the projected deficit to overall spending and revenues in FY2012. It shows that the deficit is about three-quarters the size of all non-interest spending outside of Social Security, Medicare, and defense discretionary. It is also more than three-quarters of total discretionary spending (defense and non-defense combined). It is about half the size of total revenues.

Figure 1. Selected Data from FY2012 Federal Budget

billions of dollars



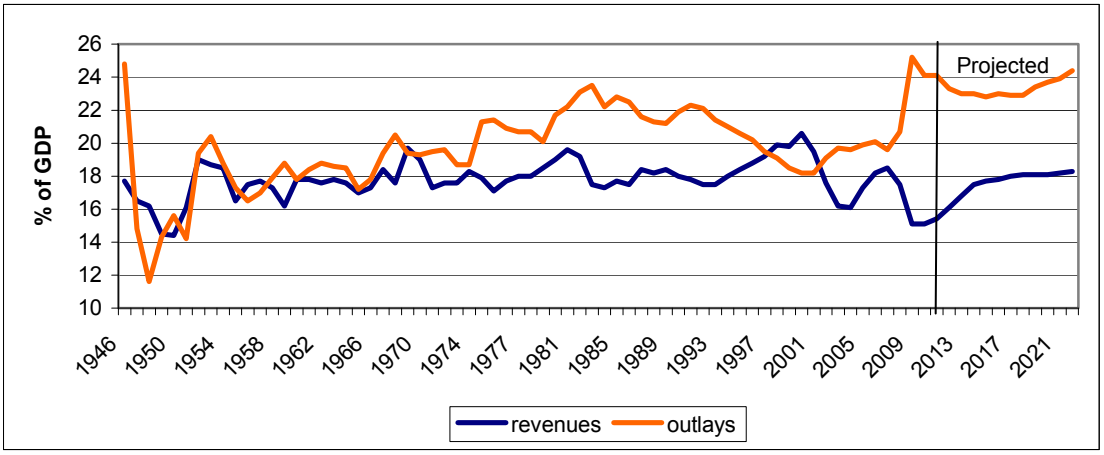
Source: CRS calculations based on CBO data.

Note: Budget deficit, spending, and revenues for 2012 are projected based on the January CBO baseline.

Budget deficits are the result of the shortfall between spending and revenue. As seen in **Figure 2**, spending in 2009 reached its highest level as a share of GDP since 1945 and revenues have reached their lowest level as a share of GDP since 1950. From 1946 to 2008, outlays averaged 19.6% of GDP, and were generally below 20% of GDP until 1975, above 20% of GDP from 1975 to 1996, and below 20% of GDP from 1997 to 2005. From 2009 to 2011, outlays averaged 24.1% of GDP. From 1946 to 2008, revenues averaged 17.8% of GDP, showing no long-term upward or downward trend from 1952 to 2007. Revenues were at least 17% of GDP in each year during that period except for 1955, 1959, 2003, and 2004, when they were between 16% and 17%. From 2009 to 2011, revenues were below 16%.

Figure 2. Federal Revenues and Outlays, Historical and Projected Under the Alternative Fiscal Scenario

1946-2022



Source: OMB and CRS calculations based on CBO data.

Notes: See **Table 1** for details on the Alternative Fiscal Scenario.

Just as recent deficits are the combination of all past outlay and revenue decisions, returning the budget to balance would be difficult without a combination of outlay and revenue changes. For instance, to return the budget to balance while maintaining 2011 revenue levels would require that outlays decline to a share of GDP last seen in the 1950s. Likewise, to balance the budget while maintaining 2011 outlay levels would require revenues to rise to their highest share of GDP ever.

Federal Spending

Total spending under the Alternative Fiscal Scenario would fall by nearly one percentage point of GDP from 2011 to 2012, and is projected to average 23.4% of GDP in the 10-year budget window. (Total spending under the CBO current law baseline never falls below 21.5% of GDP.) From 1946 to 2008, there were only three years when outlays were above 23% of GDP. By 2022, total spending is projected to exceed its 2011 share of GDP under the Alternative Fiscal Scenario—despite discretionary spending falling to its lowest share of GDP since data was first collected—because mandatory spending and net interest on the federal debt grow relative to GDP. The projected increase in net interest is due to the growth in the federal debt and the return to more normal interest rates from the below-average rates currently prevailing.

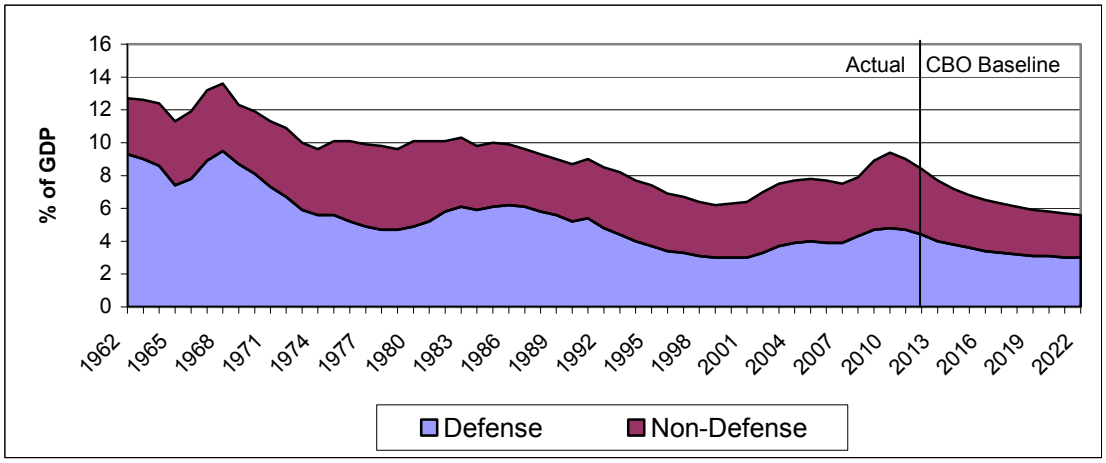
Discretionary Spending

Large budget deficits relative to GDP since 2009 have corresponded with higher levels of discretionary spending relative to GDP, but not historically high levels since data was first available in 1962, as seen in **Figure 3**. Defense discretionary spending was higher from 1962 to 1992 as a share of GDP than it was in 2010. From 1963 to 2001, defense discretionary spending generally fell relative to GDP—but not in terms of nominal dollars. It then began to grow, when overseas military operations expanded. It currently remains well below the share of GDP that prevailed before the 1990s. Non-defense discretionary spending has shown no long-term upward or downward trend relative to GDP—except for an elevated period from 1975 to 1981, it has

always stayed within 3.5% to 4.0% of GDP. Over the late 1990s, it fell to its lowest level of GDP since data has been collected, and then rose from that low base in the 2000s. It has been above its long-term average since 2009, but below the levels prevalent from 1975 to 1981. Since 2009, much of the growth in non-defense discretionary spending was a result of the 2009 Economic Stimulus Act. Most discretionary spending under this act will be completed by 2011.

Figure 3. Discretionary Spending, Historical and Projected in the Baseline

1962-2022



Source: OMB and CBO.

Note: Figure assumes that spending cuts under the Budget Control Act will occur as scheduled.

In the current law baseline, discretionary spending declines significantly relative to GDP over the next 10 years to its lowest share of GDP since data were first collected in 1962, as shown in **Figure 3**. The current law baseline assumes that discretionary spending will adhere to the levels set in the Budget Control Act. Even if the Budget Control Act's automatic "trigger" cuts are not implemented in 2013, total discretionary spending under the discretionary caps would still fall to its lowest share of GDP since 1962.

The CBO current law baseline assumes discretionary spending will fall in nominal terms (i.e., not adjusted for inflation) each year from 2011 to 2015. From 1963 to 2010, discretionary spending fell in nominal terms in only four years, most recently in 1996. Adjusted for inflation, the CBO baseline assumes that both defense and non-defense spending would fall in real terms each year from 2011 to 2022. If this occurred, it would mark a significant break from past policy, as shown in **Table 2**.

Table 2. Average Annual Real Growth Rates of Discretionary Spending Outlays

Actual and CBO Baseline, Adjusted for Inflation

	Defense	Non-Defense
2000-2008	5.1%	3.0%
2009-2010	5.7%	11.4%
2011-2022	-2.4%	-3.2%

Source: CRS calculations based on OMB and CBO data.

Notes: Data for 2000 to 2011 are actual; data for 2012 to 2022 assume that spending cuts under the Budget Control Act will occur as scheduled.

CBO includes the continuation of spending on overseas military operations at current levels (about $146 billion a year in 2012 dollars) in its baseline projection of discretionary spending throughout the 10-year budget window because it is exempt from the Budget Control Act caps. For defense, the timing and magnitude of any potential drawdown in overseas military operations could cause military spending to decline relative to the baseline, but traditionally such changes have not been motivated by deficit reduction. Even if current operations are reduced, future geopolitical events could require military personnel to be deployed elsewhere in the next 10 years, so the baseline does not necessarily overestimate future defense spending.

One macroeconomic implication of reducing discretionary spending is that most federal spending on physical capital (e.g., infrastructure) and human capital (e.g., education) is located in the discretionary portion of the budget. Economic theory predicts that a lower future capital stock would reduce the long-term size of the economy from what it otherwise would be, all else equal.[28]

In long-term projections, CBO holds discretionary spending constant as a share of GDP because it is determined annually. Because discretionary spending is held constant, it is not responsible for the growth of the budget deficit in long-term projections.

Mandatory Spending

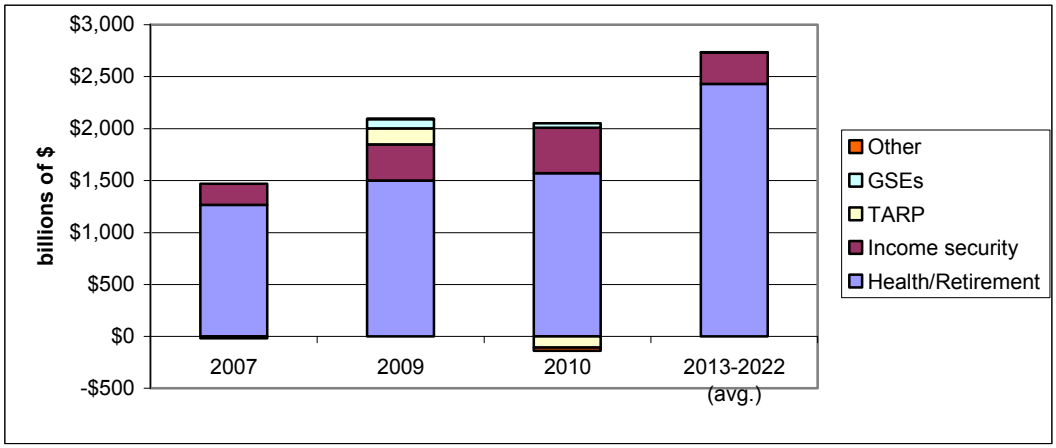
Unlike discretionary spending, mandatory spending grew rapidly from 5% of GDP in 1962 to a range of 9% to 10.5% of GDP from 1975 to 2007, peaking in recession years because of automatic stabilizers. It exceeded 13% of GDP from 2009 to 2011, marking its highest share of GDP since data were first compiled in 1962. In contrast to discretionary spending, mandatory spending is projected to continue to grow faster than inflation and exceed 13% of GDP over the next ten years under current policy. Since 1962, mandatory spending fell in nominal terms in only one year, 2010; if TARP and deposit insurance, which recorded negative outlays that year, are removed, all other mandatory spending grew in 2010.

Over the long term, the upward trend in mandatory spending in the past and future is dominated by Social Security, Medicare, and Medicaid, which accounted for about three-quarters of total mandatory spending in 2010. Between 2007 and the 2009 to 2011 period, the growth in mandatory spending was dominated by financial crisis programs, the 2009 Economic Stimulus Act spending, and automatic stabilizers (primarily located in the Income Security category). From 2007 to 2009, mandatory health and retirement programs (including Social Security, Medicare, and Medicaid) increased by $234 billion or 19%, as shown in **Figure 4**. Over the same period, income security outlays increased by $146 billion or 73%. In FY2009, TARP was created and the GSEs began to receive financial assistance, adding $152 billion and $91 billion to mandatory spending, respectively.

[28] About half of federal spending on physical capital is for defense, and reduced defense capital spending may not have the same economic effects as reduced non-defense capital spending.

Figure 4. Mandatory Spending in Selected Years

billions of nominal dollars



Source: CRS calculations based on CBO data.

Notes: Health/Retirement = Social Security, Medicare, Medicaid, Civil Service and Military Retirement, Veterans, and other health programs (net of offsetting receipts); GSEs = Government Sponsored Enterprises; TARP = Troubled Asset Relief Program; Income Security = unemployment benefits, means-tested transfer programs to households, refundable tax credits; Other = remaining programs net of offsetting receipts. Outlays can be negative for a category because offsetting receipts exceed spending or because of subsidy reestimates for credit programs. Totals for joint state-federal programs include only the federal share.

Outside of health and retirement programs, outlays on other mandatory programs are projected to decline significantly in nominal terms over the next 10 years. TARP registered negative outlays of $110 billion in 2010 and $37 billion in 2011, representing downward revisions of the previously estimated cost of the program, and is projected to record outlays of less than $1 billion per year over the next 10 years. Transfers to the GSEs declined to $5 billion in 2011, and are projected to average $3 billion per year over the next 10 years. As the economy improves, "automatic stabilizer" spending is also projected to decline: spending on income security programs more than doubled in nominal terms between 2007 and 2010, but is projected to decline from $438 billion in 2010 to an annual average of $302 billion over the next 10 years.

In long-term budget projections, rising budget deficits are driven primarily by the growth in entitlement programs for the elderly, particularly health spending. Social Security outlays are projected to rise from 4.8% of GDP today to 6.1% of GDP in 2035, and federal health outlays (mainly on Medicare and Medicaid) are projected to rise from 5.6% today to as much as 10.3% of GDP in 2035. By 2050, outlays on Social Security and health programs would exceed total revenues. In part, this growth is driven by the assumptions that go into these projections—revenues and discretionary spending are assumed to stay constant relative to GDP in the long run, whereas health spending per capita is projected to continue to grow faster than GDP per capita because it has historically grown much more quickly. If health spending per capita grew at the same rate as GDP per capita (technically, this is referred to as an excess cost growth rate of zero), much of the increase in federal spending would be avoided, although spending would still grow somewhat because of demographic changes—namely, the retirement of the baby boomers—that increased the number of recipients.[29]

[29] For more information, see CRS Report RL32747, *The Economic Implications of the Long-Term Federal Budget* (continued...)

The growth in elderly entitlement spending keeps deficits unsustainably large in the long run. Restraining the future growth rate of this spending would keep the deficit from growing, but it alone would not reduce the budget deficit in the short run. In effect, since the debt is already growing faster than GDP today, restraining elderly entitlement growth would keep the debt to GDP ratio on its current upward—and therefore, unsustainable—trajectory.[30] Most proposals to reform elderly entitlement programs would generate significant budgetary savings in the long run, but little budgetary savings in the short run, partly because most proposals exempt current retirees from reform and partly because the savings from these changes would compound over time. For example, immediately reducing excess cost growth for federal health spending to zero would reduce federal spending by 2% of GDP after 14 years, but by 0.7% of GDP after 5 years.[31]

Revenues

In 2009 and 2010, revenues were at historically low shares of GDP across all major categories—individual income taxes were at their lowest share of GDP since 1950, corporate income taxes were at their lowest share of GDP since the 1930s, social insurance receipts were at their lowest share of GDP since the 1970s, and excise taxes were at their lowest share of GDP since 1934, the first year for which data are available. In recent years, most revenues have come from the individual and social insurance categories. In 2011, income tax revenue rose as a share of GDP because of the economic recovery, but social insurance receipts declined as a share of GDP because of the payroll tax cut (P.L. 111-312), and total revenues remained below historical averages as a share of GDP.

Revenues in the CBO "current law" baseline are projected to exceed 20% of GDP from 2015 on, which is higher than the historical average. This increase occurs primarily because CBO assumes that the "Bush tax cuts" and "AMT patch" expire as scheduled in current law. If the tax cuts and AMT patch continue to be extended (as assumed in the Alternative Fiscal Scenario), revenues would be about 2% of GDP lower in 2014, rising to 2.5% of GDP by 2021. In this scenario, total revenues would gradually increase relative to GDP over the next 10 years due to the improvement in the economy (initially) and "real bracket creep," returning to their historical average around 2014. Real bracket creep refers to the fact that the same tax structure generates more revenue relative to GDP when incomes rise. But revenues would not return to 18.5% of GDP, which is the highest share of GDP that revenues have reached since the Bush tax cuts were fully implemented, at any point in the next decade under the Alternative Fiscal Scenario because of the enactment of additional tax cuts since then.

If policymakers decided to increase revenue to reduce the deficit, five broad choices are often discussed[32]:

- redesigning the structure of the tax system;

(...continued)

Outlook, by Marc Labonte.

[30] This would be the case under the assumptions that discretionary spending and revenues stay around the historical average, as opposed to revenues being determined by current law.

[31] Congressional Budget Office, *Long-Term Budget Outlook*, June 2011, Figure 3-4.

[32] For a further analysis, see CRS Report R41641, *Reducing the Budget Deficit: Tax Policy Options*, by Molly F. Sherlock.

- adding new revenue sources, such as a carbon tax or a value added tax (VAT);
- increasing existing taxes;
- "broadening the tax base" by eliminating tax expenditures (deductions, exemptions, and credits); or
- allowing tax cuts to expire as scheduled.

Redesigning the tax system or adding new revenue sources could theoretically improve economic efficiency and might be more appealing to some than increasing existing taxes, but in practice, pressure to compensate those made worse off from these changes may result in those policies raising little additional revenue. Generally, economists favor eliminating tax expenditures over raising marginal tax rates on efficiency grounds, although some specific expenditures may promote economic efficiency. Tax expenditures have also been criticized on the grounds of equity and complexity.[33]

For long-term projections, defining revenues under current policy is problematic. Under current law, revenues are projected to gradually rise relative to GDP over the next 75 years because some parts of the tax system, notably the AMT, are not indexed for inflation and other parts of the system would experience "real bracket creep."[34] If current policy were instead considered to be defined as setting revenues at current levels or returned to historical levels, revenues would be insufficient to match the long-term growth in spending under current policy, and progressively larger budget deficits would result.

Conclusion

Budget deficits have reached historically high and unsustainable levels since 2009 because spending has been at its highest share of GDP since 1945 and revenues have reached their lowest share of GDP since 1950. By 2017, deficits decline to about 1% of GDP—a sustainable level in the sense that it would cause the federal debt to fall relative to GDP—under the official CBO "current law" baseline. This baseline makes several assumptions that would mark a significant change from current policy—that tax provisions such as the Bush tax cuts and AMT patch would be allowed to expire as scheduled although they have already been extended at least once, that cuts to Medicare physician payments would be allowed although Congress has routinely prevented those cuts, and that discretionary spending will fall to historically low shares of GDP under the Budget Control Act. Under CBO's Alternative Fiscal Scenario, budget deficits under a continuation of current policy (as opposed to current law) would remain between 5% and 6% of GDP and would continually rise as a share of GDP after 2014 over the next 10 years.

One policy goal is to place the deficit on a sustainable path so that the publicly held debt stabilizes as a share of GDP. For illustrative purposes, CRS estimates that to stabilize the debt as a share of GDP at its projected 2012 level (73% of GDP) would require average annual budget deficits of 2.8% of GDP over the next 10 years. In dollar terms, this would amount to a deficit of about $400 billion in 2012, rising to about $550 billion in 2015. Compared with the "current

[33] For more information, see CRS Report RL33641, *Tax Expenditures: Trends and Critiques*, by Thomas L. Hungerford.

[34] The reason regular AMT "patches" have been enacted in recent years is to prevent an increase in taxpayers subject to the AMT due to inflation.

policy" baseline, this would require some combination of spending cuts and tax increases equivalent to more than $700 billion in 2012 and $400 billion in 2015.

Balancing the budget through changes to one subsection of the budget is not mathematically possible at 2012 levels. For example, total spending outside of Social Security, Medicare, defense, and net interest is projected to be roughly three-quarters the size of the budget deficit in 2012. Total revenues are projected to be about half the size of the deficit in 2012. To date, legislation to reduce the budget deficit has focused on reducing discretionary spending, but the budget deficit in 2012 is projected to be more than three quarters the size of total discretionary spending (defense and non-defense combined).

In long-term projections of current policy, unsustainable budget deficits are largely driven by the growth in elderly entitlement spending. By 2050, outlays on Social Security and health programs are projected to exceed total revenues. However, because deficits are already at unsustainable levels today, restraining the future growth rate of elderly entitlement spending alone would still leave an unsustainably large budget deficit—in effect, it would simply keep the deficit from getting larger. Most proposals to curb the future growth of these programs call for gradual changes that exempt those who are now elderly or near-elderly. These types of proposals typically result in modest deficit reduction in the short term.

The Budget Control Act is projected to reduce the deficit by about 1% of GDP on average over the next 10 years, mostly through discretionary spending cuts. If other current policies remain in place, this act would not appear to reduce the deficit enough to restore fiscal sustainability. In this scenario, revenues as a share of GDP will remain below their historical average and mandatory spending will remain at historically high levels as a share of GDP. Revenue levels are currently low because of the recession and tax cuts. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 further increased the deficit by an estimated $374 billion in 2011, of which $204 billion is attributable to the extension of expiring tax provisions.

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