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The Federal Budget: Understanding Fiscal Outcomes

The budgetary power of Congress is a core responsibility that affects national economic conditions and future policy choices. This In Focus summarizes the role of Congress in the federal budget process, describes the key budget categories, and discusses recent budgetary trends and projections.

Framework and Major Components

The legislative powers of Congress over the federal budget are collectively known as the "power of the purse." These powers include the ability to collect and disburse resources and to borrow from the public, and are more formally defined as spending, revenues, and debt in federal budget terminology. **Spending** moves resources from the government to individuals, firms, and institutions. **Revenues** move resources in the opposite direction. **Debt** results from federal government borrowing. Budget outcomes (like how much revenue is raised or outlays are spent) are often measured annually over a **fiscal year**, which begins October 1 and ends September 30.

Federal spending is measured in two ways. **Budget authority** allows for federal agencies to enter into obligations. **Outlays** are federal funds disbursed to fulfill obligations paid by the Treasury. For example, if Congress appropriates $1 million for a program through legislation, that $1 million represents budget authority. However, no outlays occur until Treasury makes payments from the $1 million appropriated by Congress. Typically there is a lag between when budget authority is granted and when outlays occur. In some cases, appropriated funds are never disbursed.

Spending programs are often split into three components in budgeting discussions. **Discretionary spending** refers to spending that is controlled by appropriations acts. This includes most spending for defense programs and federal agencies, and is typically approved on an annual schedule known as the budget cycle. **Mandatory spending** represents federal spending controlled outside of appropriations acts. Social Security, Medicare, and Medicaid spending comprise most of mandatory spending, and are not usually tied to the budget cycle. **Net interest spending** equals government payments on federal debt offset by interest payments received from loans and federal trust funds. The amount of federal debt and interest rates determine the size of net interest payments.

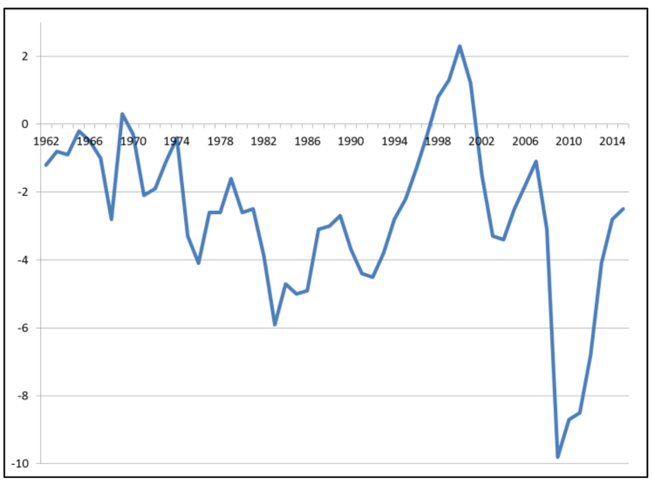
Federal revenues come from individual income taxes, corporate income taxes, payroll taxes, and many other sources. Income taxes include the **individual income tax**, which draws from a varying percentage of personal earnings; and the **corporate income tax**, which draws from a percentage of C corporation profits (varying by profit level). **Payroll taxes** are another major source of revenue, and include matching wage taxes on employers and employees that contribute to Social Security and Medicare trust funds. The government also receives money from hundreds of other taxes, fees, and fines, including **excise taxes** (taxes on certain consumption), **estate and gift taxes** (taxes on transfers of certain property), **customs duties** (taxes on imports), and Federal Reserve earnings.

The federal government incurs a **deficit** when outlays exceed revenues in a given year. If instead federal revenues exceed outlays, then the difference generated is known as a **surplus**. As deficits and surpluses are measured over the course of a defined period of time (the fiscal year), they are sometimes referred to as "flow" variables. **Debt** measurements may be taken at any point in time and represent the accumulation of all previous net government borrowing activity (sometimes described as "stock" variables). Federal debt increases when there are net budget deficits and outflows made for federal credit programs and with increases in intragovernmental debt, which is generated by trust fund surpluses. Budget surpluses, net inflows to credit programs, and decreases in intragovernmental debt reduce federal debt.

Recent Trends

Figure 1. Inflation-Adjusted Federal Surpluses and Deficits, FY1962-FY2015

(as a % of Gross Domestic Product)



Source: Office of Management and Budget, *Historical Tables*, Table 1.2.

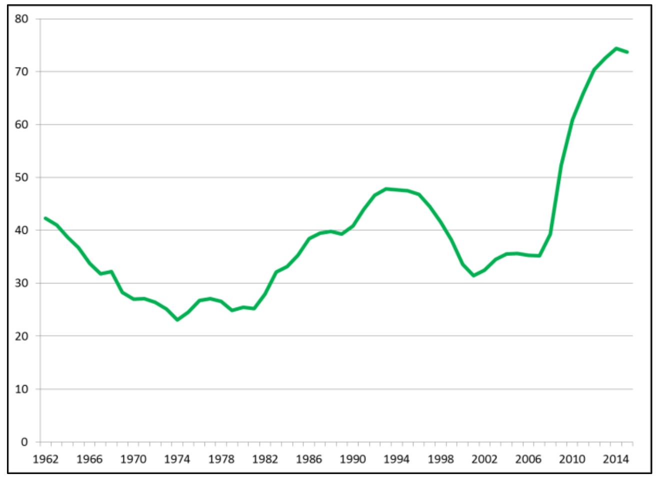
Figure 1 shows the inflation-adjusted federal budget outcomes from FY1962 through FY2015. From FY1962 through FY2015, federal outlays exceeded revenues by an average of 2.6% of annual gross domestic product (GDP). (When comparing deficit and debt totals over time, measuring their values as a percentage of GDP helps to account for the effects of inflation.) Over those 54 years, the budget recorded a surplus on five occasions, most recently in FY2001. In the other 49 fiscal years, the budget produced a deficit. The federal budget recorded inflation-adjusted deficits in FY2008 through FY2010 that were higher than they were at any point since the end of World War II. Increased federal spending and reduced revenues related to the Great Recession and spending commitments to defense- and veterans-related activities were among the largest contributing factors to those outcomes.

Budget deficits declined for five consecutive years from FY2011 through FY2015. Contributors to that decline include decreased spending and increased revenues attributable to the economic recovery, reductions in discretionary spending in accordance with statutory caps established by the Budget Control Act of 2011 (P.L. 112-25), and low interest payments (due to historically low interest rates).

Persistent and occasionally large budget deficits since FY2001 have contributed to historically high levels of federal debt held by the public (which includes all debt except intragovernmental debt). Federal debt held by the public declined from 74.4% of GDP at the end of FY2014 to 73.7% of GDP at the end of FY2015. The FY2014 total represented the largest stock of inflation-adjusted publicly held debt since FY1950 (78.5% of GDP). **Figure 2** displays federal debt held by the public amounts from FY1962 to FY2015.

Figure 2. Inflation-Adjusted Federal Debt Held by the Public, FY1962-FY2015

(as a % of Gross Domestic Product)



Source: Office of Management and Budget, *Historical Tables*, Table 7.1.

Fiscal Outcomes

Many economists support the use of budget deficits as an economic stimulant during a downturn, particularly in cases where standard monetary policy options are unavailable. However, experts caution that structural deficits, which describe budget conditions that produce deficits in all economic conditions, may lead to adverse outcomes. In prosperous economic periods, deficit spending may replace, or "crowd out," private investment and, as those deficits will incur borrowing costs, could dampen long-run economic productivity. As borrowing costs rise with interest rates, deficit spending has a larger effect on the long-term budget outlook when interest rates are relatively high than it does when interest rates are low. Debt financing in prosperous economic periods may also reduce the ability to utilize deficit spending when faced with poor economic conditions.

In the future, extremely high deficit or debt levels may have unintended macroeconomic effects if individuals and firms lose confidence in the ability of the federal government to fulfill its borrowing obligations, which may increase federal borrowing costs and have implications for financial markets. There are past examples of foreign governments experiencing the adverse effects of a deteriorated fiscal position. There are, however, no examples of such an occurrence taking place in modern U.S. history.

Outlook

Although inflation-adjusted deficits have declined in recent years, forecasts produced by both the Congressional Budget Office (CBO) and Office of Management and Budget (OMB) project deficit increases in the 10-year budget window. Increases in real outlays (through rising mandatory spending commitments due in part to increased Social Security and Medicare payments) and net interest obligations (due largely to projected increases in real interest rates) more than offset continued inflation-adjusted declines in discretionary spending. Revenues are projected to remain relatively level over the 10-year period. In March 2016, CBO's forecast projected a budget deficit equal to 2.9% of GDP in FY2016 and 4.9% of GDP in 2026. The July 2016 OMB budget forecast projected deficits of 3.3% of GDP in FY2016 and 4.8% of GDP in FY2026.

Forecasts over a longer time horizon also project increases in deficit and debt levels. CBO's June 2016 *Long-Term Budget Outlook* projects that publicly held federal debt, which was 74% of GDP at the end of FY2015, will equal 141% of GDP in FY2046 under present law. The projected increase is attributable to growth in outlays outpacing that of revenues (resulting in increasing real deficits) and to interest rates returning to levels that are roughly in line with their historical averages.

CBO projects that in order for inflation-adjusted publicly held federal debt to reach its 50-year historical average of 39% of GDP in FY2046, revenue would need to increase or noninterest spending would need to decrease by approximately 2.9% of GDP every year for the next 30 years.

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