CRS INSIGHT

The Federal Budget Deficit and the Business Cycle

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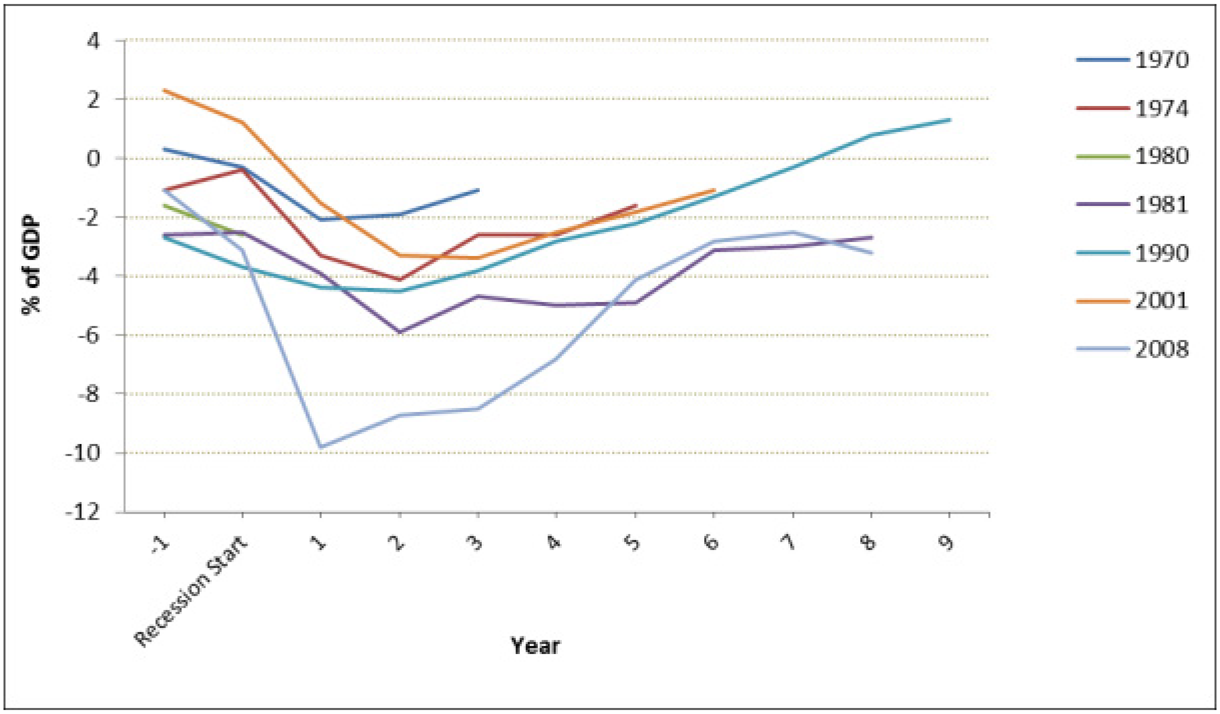
The annual federal budget deficit has fallen significantly over the course of the current economic expansion, from a high of 9.8% of gross domestic product (GDP) in FY2009 to 3.2% of GDP in FY2016. However, the debt held by the public has continued to increase, and was equal to 76.6% of GDP at the end of FY2016, the highest level since FY1950. This Insight discusses how deficits responded to previous expansions and recessions. Based on historical experience, recent trends toward achieving fiscal sustainability are likely to reverse the next time the economy enters a recession.

The Deficit and the Economy

The recent rise and decline in the deficit mirrors past business cycles. In each business cycle since 1970, deficits have grown during the recession and improved during the next expansion. From the year before a recession began to the year a recession ended, the deficit has increased or the surplus has decreased by an average of 3.1 percentage points of GDP, as seen in **Figure 1**. The largest increase occurred during the 2007-2009 "Great Recession," when the deficit increased by 8.1 percentage points. Each recession (not including the first of the two "double dip" recessions which started in 1980) was accompanied by two to four years of progressively larger deficits.

Figure 1. Budget Deficits During Recessions and Expansions



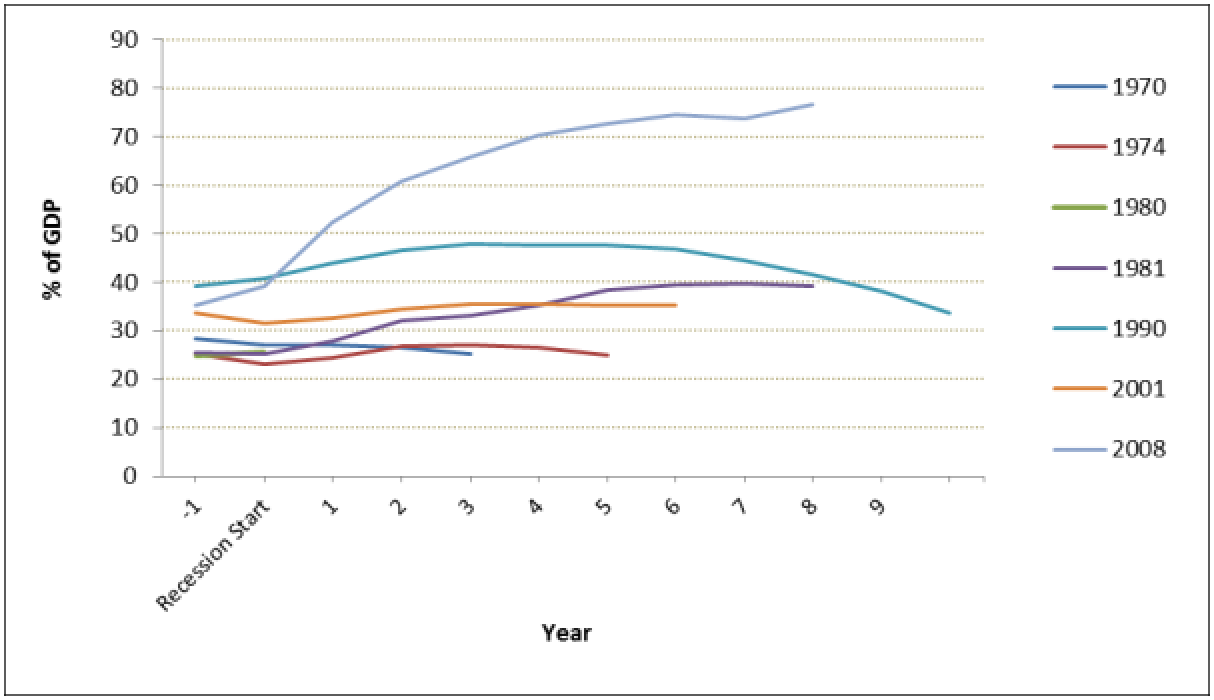
Source: CRS calculations based on [OMB](), [NBER]() data.

Notes: Positive numbers are surpluses and negative numbers are deficits. Legend shows year in which recession started. Business cycles have been redated to fiscal years.

In each expansion since FY1970, the deficit gradually shrank but not back to where it had been in the previous expansion, except for the 1990s expansion, when the budget moved into surplus. The 1990s pattern was the norm from World War II until FY1970. The deficit following the Great Recession was larger at its peak than in any recession since World War II. Despite rapid improvement, the deficit was still larger for FY2016 than it was at the end of any other expansion over the same period.

Although the federal budget was in deficit in all but four years since FY1970, during most expansions deficits were small enough to reverse the increase in the debt-to-GDP ratio that had occurred in the preceding recession, as shown in **Figure 2**. The two exceptions were the two expansions that featured large budget deficits—the one following the 1981 recession (a 13.8 percentage point increase in the debt to GDP ratio) and the current one (a 41.4 percentage point increase—more than double the pre-recession ratio).

Figure 2. Publicly Held Debt During Recessions and Expansions



Source: CRS calculations based on OMB, NBER data.

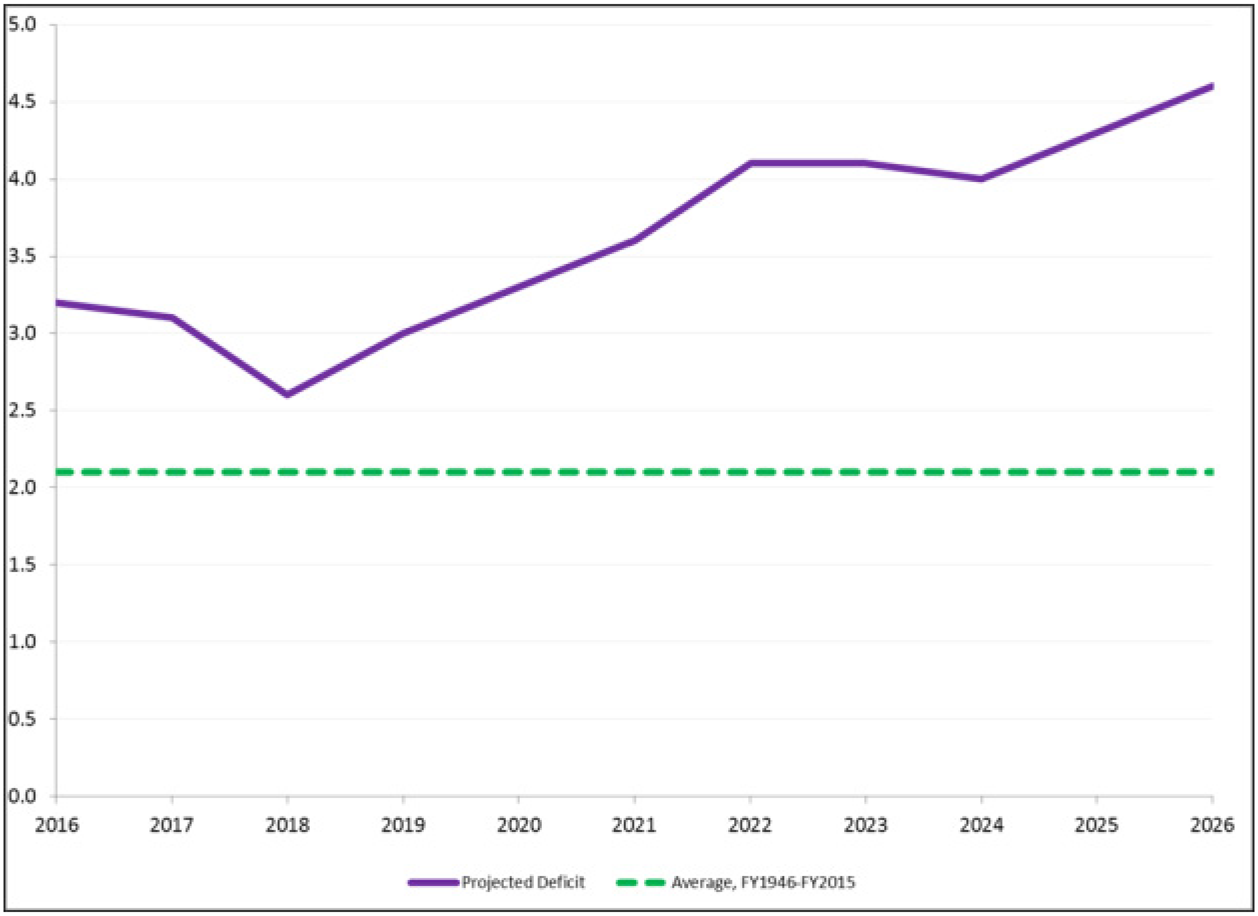
Notes: Legend shows year in which recession started. Business cycles have been redated to fiscal years.

The deficit's cyclical pattern can be attributed to "automatic stabilizers" and to fiscal policy changes that Congress has frequently enacted in response to recessions. "Automatic stabilizers" refer to spending programs and tax provisions that cause the budget deficit to move in tandem with the business cycle without any change in law. As incomes and employment fall, the existing structure of the federal tax system automatically collects less revenue and spending on mandatory income security programs, such as unemployment insurance, automatically rises. The opposite effect occurs during expansions. CBO estimates that the share of the deficit attributable to automatic stabilizers has fallen from 2.2% of GDP in FY2010 to 0.5% of GDP in FY2016. In other words, once cyclical elements are removed, an underlying "structural deficit" of 2.7% of GDP remains in FY2016.

Although it has been unusually weak, the current expansion is already the fourth longest since World War II. The longest expansion on record lasted 10 years, according to NBER. Turning points are hard to predict, but by the "law of averages" another recession can be expected at some point in the next few years. In each expansion since 1970, the smallest deficit or largest surplus was achieved in the year before the subsequent recession. **Figure 3** shows that the FY2016 deficit is still above the average since World War II. Of course, if the expansion continues into future fiscal years, that would put downward pressure on the deficit, but CBO projects that, as automatic stabilizers fall to zero, the deficit would fall no lower than 2.6% of GDP in the next 10 years under current law—which would still be above the postwar average of 2.1% of GDP.

Figure 3. Projected Federal Deficits, FY2016-FY2026

(as a % of GDP)



Source: CBO and OMB.

Policy Implications

Perceptions of recent fiscal improvement may be distorted by the economy's improvement. Although the deficit has decreased significantly since FY2009, it is still not projected to be small enough under current law to stabilize the debt-to-GDP ratio—a basic metric of fiscal sustainability. The publicly held debt is a larger share of GDP today than in any other year in the history of the United States except during World War II. Seven years into the current expansion, the deficit is still above its post-war average. When the economy enters the next recession, the deficit could increase by more or less than the average of 3.1 percentage points of GDP it has increased in past recessions since 1970. Even absent policy changes, the deficit would be expected to increase in the next recession because of automatic stabilizers. Reducing the deficit today would give policymakers more "fiscal space" to use expansionary fiscal policy (i.e., increase the budget deficit) to offset the next recession—the subject of recent CRS Insight IN10624, *"Fiscal Space" and the Federal Budget*, by Grant A. Driessen and Marc Labonte.

From a macroeconomic perspective, deficit reduction is most beneficial when the economy is at full employment. The length of the expansion and the current unemployment rate would seem to indicate that the economy is near full employment. However, some economists believe that there are forces preventing the economy from reaching full employment, such as underlying "slack" in the labor market or "secular stagnation." If so, the macroeconomic argument for deficit reduction would be less clear cut.