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IN FOCUS

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Debt and Deficits: Spending, Revenue, and Economic Growth

The Constitution provides Congress with the authority to manage the federal budget through its "power of the purse." This In Focus summarizes federal budget and borrowing outcomes and trends for federal spending and revenues.

The Federal Budget Deficit

The federal government incurs a budget deficit when total spending exceeds revenues over the course of a fiscal year. A budget surplus occurs when revenues exceed outlays. Budget outcomes are dependent on general economic conditions. Net deficits tend to decline in periods of high economic growth due to both increased revenues (through a rise in earnings and subsequent tax payments) and reduced outlays (through a decline in demand for unemployment benefits and other programs). Conversely, deficits tend to increase in periods with lower economic growth.

The federal budget has not produced a surplus since FY2001. Reduced revenues and increased spending led to deficits in ensuing years, and the Great Recession and federal response produced deficits in FY2008-FY2010 (averaging 9.0% of gross domestic product [GDP]), which were the largest of the post-World War II era. Following a period of smaller deficits, real deficits have increased in each year since FY2015. The budget recorded a deficit of 4.0% of GDP in FY2018, which is larger than the average deficit from the preceding 50 years (2.9% of GDP from FY1968 to FY2017).

The *2018 Long-Term Budget Outlook* issued by the Congressional Budget Office (CBO) in June projects that under current law, deficits will remain higher than their historical average for the next 30 years, with deficits of 5.1% of GDP in FY2028 and 9.5% of GDP in FY2048.

Federal Debt

Federal debt is the accumulation of government borrowing activity. Debt levels increase when there are budget deficits, net outflows for federal credit programs, or increases in intragovernmental debt. Treasury is tasked with managing debt in a manner that maximizes transparency and minimizes interest costs. The debt measurement generally of chief interest to economists is publicly held debt, which excludes debt held in federal government accounts.

Changes in federal debt reflect implicit policy choices concerning the distribution of government activity across generations. Debt increases in one time period constrain the choices available in later periods. Large and persistent debt levels may reduce public confidence in the government's ability to fulfill its borrowing obligations, which could increase long-term borrowing costs.

Debt levels generally have grown in recent decades. Publicly held debt was estimated to be 78% of GDP at the end of FY2018, the highest value since FY1947. CBO's long-term forecast projects steady increases in publicly held debt, reaching 96% of GDP by FY2028 and 152% of GDP in FY2048.

Congress also controls debt through the statutory debt limit, which constrains the amount the Department of the Treasury may borrow. The debt limit is currently suspended and scheduled to be reinstated on March 1, 2019.

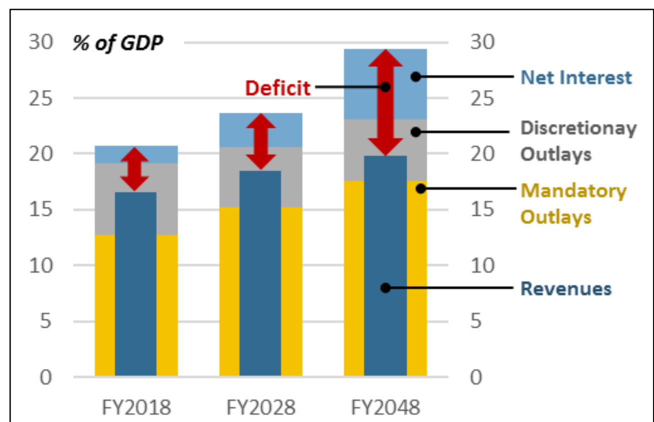
Trends in Spending and Revenue

Mandatory Spending

Mandatory spending covers spending for programs not controlled by annual appropriations acts. It includes spending for Social Security, Medicare, Medicaid, and other health and old-age programs. Mandatory spending as a share of GDP has increased gradually over time. Mandatory outlays were estimated to be 12.7% of GDP in FY2018 (61% of total federal spending), above the FY1968-FY2017 average of 9.8% of GDP.

Mandatory spending is projected to continue growing as a share of the economy, due to increased eligibility for old-age and retirement programs, increased longevity of participants in those programs, and rising health care costs. The latest CBO long-term baseline projects that mandatory spending will equal 15.2% of GDP in FY2028 (which would be the highest value on record) and 17.6% of GDP in FY2048. Rising Social Security and Medicare spending explains most of those future increases.

Figure 1. Spending, Revenues, and the Deficit: FY2018, FY2028 and FY2048



Source: CRS graphic using Congressional Budget Office data. FY2028 and FY2048 values are baseline projections.

Discretionary Spending

Discretionary spending covers spending for programs controlled by annual appropriations laws, including for most federal agencies and national defense programs. Discretionary spending as a share of GDP has declined gradually over time. Discretionary outlays were estimated to be 6.4% of GDP in FY2018 (31% of total federal spending) below the FY1968-FY2017 average of 8.5% of GDP. Total FY2018 discretionary spending was almost equally split between defense (49%) and nondefense programs (51%).

The CBO long-term baseline projects that discretionary spending will be 5.4% of GDP in FY2028 (which would be the lowest value on record) and 5.5% of GDP in FY2048. Future trends in discretionary spending will depend in part on the congressional response to the FY2019-FY2021 discretionary spending caps imposed by the Budget Control Act (P.L. 112-25). CBO projections assume the discretionary spending caps proceed as scheduled, though they were modified to allow for greater spending from FY2013 through FY2019.

Net Interest

Net interest payments measure the payments made by the federal government to finance its borrowing, and they are a function of the stock of debt held by the public and prevailing interest rates. Net interest payments were estimated to equal 1.6% of GDP in FY2018 (8% of total federal spending), below the FY1968-FY2017 average of 2.0% of GDP. The latest CBO long-term baseline projects that net interest payments will rise as interest rates return to historical norms, reaching 3.1% of GDP in FY2028 and 6.3% of GDP in FY2048.

Revenue

Federal revenues come from several sources, including individual income taxes, corporate income taxes, and excise taxes. Revenues also are collected through payroll taxes, which are dedicated to social insurance programs. Revenue as a share of GDP has fluctuated over time. Revenues were estimated to be 16.6% of GDP in FY2018, below the FY1968-FY2017 average of 17.4% of GDP.

Revenues as a share of GDP were 17.3% in FY2017, in line with the historical average. The decline in revenues as a percentage of GDP in FY2018 is largely attributable to the 2017 tax revision (P.L. 115-97). On net, taxes paid by individuals and businesses are expected to be lower in 2018 than they were in 2017. Most of the provisions affecting individuals, however, are scheduled to expire at the end of 2025.

The CBO long-term baseline projects that revenues will be 18.5% of GDP in FY2028. This higher level of revenues as a percentage of GDP was last observed in the late 1990s and early 2000s, when the budget last recorded a surplus. Future trends in revenues depend in part on the congressional response to the expiring individual income tax reductions and other provisions in the 2017 tax revision that raise additional revenue over time. Postponed health taxes also are expected to begin generating additional federal revenue as they take effect over time.

Long-term projections put revenues at 19.8% of GDP by FY2048. Most of the increase in revenues as a share of GDP is attributable to a rise in individual income tax receipts. Revenues tend to rise relative to the size of the economy when income rises faster than inflation, pushing taxpayers into higher tax brackets. Although long-term projections show revenues rising relative to the size of the economy, projected increases in revenues do not keep pace with projected increases in spending, and the result is rising deficits and higher levels of debt.

Causes and Consequences of the Debt and Deficits

If the persistent federal budget deficits and growing federal debt that is projected through FY2048 are allowed to occur, this outcome would hurt the economy and constrain future budget policy. Specifically, the accrual of debt

- financed from domestic sources would reduce national saving and income in the long term, reducing investment in capital that leads to productivity growth and higher wages;
- financed from foreign sources would increase the trade deficit and the obligations to pay foreign investors future returns;
- would increase the government's interest costs—constraining the ability of lawmakers to encourage growth-enhancing investments, such as infrastructure;
- would limit lawmakers' ability to respond to future recessions, natural disasters, or other unforeseen events.

In some cases—such as in Iceland and Greece—large federal debt and deficits have led to financial crises where investors were unwilling to finance government borrowing without receiving very high interest rates along with commitments to sharply reduce government deficits. Although the tipping point for this type of event is unknown, the International Monetary Fund concluded the near- and medium-term risk for the United States to be low.

Magnitude of Policy Changes Required to Address the Deficit

The CBO *2018 Long-Term Budget Outlook* estimated the magnitude of policy adjustments that would be required to meet two federal debt targets for FY2048—maintaining the current level of 78% of GDP and the 50-year average of 41% of GDP. If addressed beginning in FY2019, maintaining debt at its current level (78% of GDP) could be attained by reducing spending, increasing revenue, or a combination of the two by 1.9% of GDP (3.0% of GDP to meet the 50-year average of debt as a percentage of GDP). For example, this change could involve a 10% (15%) cut in spending or an 11% (17%) increase in revenues. Smaller near-term changes or delays in making these changes would require even larger future changes to meet either of these goals.

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