Throughout its history, the U.S. federal government has often operated under a budget deficit, and has always held a federal debt. Throughout this time there have been many debates over these issues, and the current contest over the presence of large deficits and the size of the debt is not surprising. However, with the drastic increase of the deficit the past few years, and projections that show the persistence of large deficits because of mandatory spending, the stakes seem to be as high as ever in U.S. history.

Deficit financing and its consequences are important for two main reasons. First, it has an impact on the economy. Deficit spending can stimulate the economy, a premise that is widely accepted among economists. However, the resulting debt caused by the deficit can be a detriment to the economy in the future, since revenues must be used to pay back the debt instead of on current projects. In addition, analysts also use the debt held by the public to measure the impact of the federal government’s borrowing on the economy. According to the Congressional Research Service, “It is this portion of federal debt that not only reflects the amount of the nation’s wealth invested in federal government securities rather than in private investment, but also determines the level of real resources the government must acquire to make interest and principal payments. The debt held by government accounts is the total net amount of federal debt issued to specialized federal accounts, primarily trust funds. It represents internal transactions of the federal government.”

Second, citizens believe that it is an important issue. A recent poll found that 81% of Americans view the deficit as a major problem that must be addressed immediately. In addition, 22% of voters stated that the deficit was the top issue the government should address, second only to those that felt job creating and economic growth was the most important issue. Despite their belief that the deficit and debt are important issues, many Americans misunderstand their causes.

**Definitions**

**Budget Deficit**: The difference between government revenues and outlays in a fiscal year equals the budget deficit or surplus. Simply put, a budget deficit results when government spending exceeds the amount of revenue it brings in.

**Federal Debt**: The gross federal debt is made up of the debt held by the public plus the debt held by government accounts. The debt held by the public is the total net amount borrowed.
from the public by the federal government to cover its budget deficits over the years. The debt held by government accounts is the total net amount of federal debt issued to specialized federal accounts, primarily trust funds. The role of debt can be an important part of a budget, most notably when used to finance projects that have a long useful life, such as highways and other infrastructure. At the state and local level, spending on capital projects such as these is often funded with bond debt, but at the federal level, there is no distinction in the budget between spending on current operations and spending on capital projects.

Debt Ceiling: The Second Liberty Loan Act was passed in 1917 and placed a statutory limit on the amount of federal debt the U.S. government could incur. The current cap is set at $14.3 trillion.

Mandatory Spending: Mandatory spending includes programs which are funded by eligibility rules or payment rules. Most of these are entitlement programs. For instance, when Congress creates a program, it also determines who is eligible for the program and any other criteria it may want to lay out. How much is appropriated for the program each year is then determined by estimations of how many people will be eligible and apply for it, and not by a fixed Congressional appropriation.

Discretionary Spending: Refers to the portion of the budget which goes through the annual appropriations process. In other words, Congress directly sets the level of spending on programs which are discretionary.

HISTORY OF U.S. DEFICITS AND THE NATIONAL DEBT

The United States government often operates in a deficit, and has held a debt since its inception. In fact, the U.S. Constitution states that Congress shall have the power to “borrow Money on the credit of the United States.” This was reaffirmed with the 14th Amendment, which states that “the validity of the public debt of the United States, authorized by law…shall not be questioned.” Indeed, the presence of deficits and debt has been consistent throughout America’s history.

From 1796 to 1811, the U.S. government had only two deficits, allowing it to almost succeed in paying off debts incurred during the Revolutionary War. However, the onset of the War of 1812 caused the debt to grow dramatically. This same pattern occurred in the years leading up to both the Civil War and World War I. During World War I, the deficit made up more than 10% of gross domestic product (GDP) for the first time in U.S. history. The debt then increased dramatically during the Great Depression and World War II, as the country ran deficits to fund the New Deal policies and the war effort. From 1943 to 1945, the deficit was more than 20% of GDP each year, and reached the highest point in history in 1943 at 28.1% of GDP. Once the war ended, the deficits dropped dramatically, and the federal budget was in surplus for a number of years. From 1971 to 1997, the U.S. consistently operated under a deficit, fluctuating from $22 billion to $221 billion, however, this never made up more than 6% of GDP. Between 1998 and 2001, the federal government ran surpluses, even reaching $236 billion in 2000.

According to a report published by the Congressional Budget Office (CBO) in 2001, current law projections showed that if the federal government continued to operate in a surplus, the U.S. government would have been able to pay off all redeemable federal debt by 2006. However, the trends in spending and taxation changed, and since 2001, a deficit has been incurred each year, reaching as high as $1.4 trillion in 2009, or 10% of the nation’s GDP. This is historically significant, since it is the first time since World War II that the deficit has been more than 10% of GDP. The many years of operating under a deficit have caused the federal debt to grow to surpass $10 trillion in 2008; currently, it is about $14 trillion.

CAUSES OF DEFICITS SINCE 2001

There are two main drivers of the increase in budget deficits since 2001 and thus the increase of the federal debt: a decrease in revenues caused by the economic downturn and tax cuts, and an increase in spending since 2001.

In 2000, federal government revenues were 20.6% of GDP, the highest level since World War II. This was due to large increases in individual income tax revenues during the 1990s. In 1993, Congress passed and President Clinton signed the Deficit Reduction Act of 1993, which increased the top income tax rate to 39.6% for top earners, and created a 35% income tax rate for corporations. This, in combination with a strong economy during the late 1990s, created high revenues. By 2010, revenues had fallen to 14.9% of GDP, the lowest level since 1950. This decline in revenues was caused by several factors.
In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act. This act made significant changes in the U.S. tax code; most notably, it lowered the rates of individual income taxes, as well as capital gains taxes. In addition it made sweeping reforms to taxation of retirement plans. Many of the changes in this act were designed to slowly be phased in over a nine-year period, but were accelerated by the Jobs and Growth Tax Relief Reconciliation Act of 2003. In addition, the 2003 act lowered taxes further on income from dividends and capital gains. Together, the 2001 and 2003 acts are more commonly known as the “Bush tax cuts.”

These acts were designed to sunset, or revert to the previous rates and provisions on January 1, 2011. However, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended these provisions for two additional years. The Pew Charitable Trusts recently released a report titled “The Great Debt Shift: Drivers of the Federal Debt Since 2001,” which studied the differences between the original debt estimates the CBO made in 2001, and its current estimates. Pew estimates that the 2001 and 2003 tax cuts made up about 13% of the change in CBO debt estimates, while the 2010 tax legislation made up 3%, and other tax cuts made up an addition 5% of the change.

Even without the changes in the tax code, revenue still would have fallen in the last decade. Though revenues had dropped from 20.6% of GDP in 2000 to 16.1% in 2004, they had started to increase. By 2007, they made up 18.7% of GDP, however, the recession caused them to fall once again, and by 2010, they had fallen to 14.9%. The Pew report estimates that 28% of the accumulation of debt since 2000 is due to revenue changes caused by the economic downturns, even when controlling for tax cuts enacted in that period (an additional 7% of the change is due to other technical and economic factors).

The other major cause of the increase in federal deficit since 2001 is increased spending. In 2000, federal outlays were 18.2% of GDP, the lowest point since 1966. This increased as the U.S. entered wars in Afghanistan and Iraq, and by 2006 it was 20.1% of GDP. Outlays experienced a large jump to 25.0% of GDP in 2009, in part due to the government’s efforts to stimulate the economy, the highest level since 1947 when the country was recovering from the depression caused by World War II and the New Deal programs.
decreased to 23.8% of GDP. This increased spending, in addition to the decrease in revenue addressed earlier, has added to the debt since 2001, and according to the Pew study, each of the following factors are responsible for the increase in these proportions: increases in net interest caused by a larger federal debt (11%), the operations in Iraq and Afghanistan (10%), other non-defense spending (10%), the American Recovery and Reinvestment Act (6%), other defense spending (5%), the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (2%), and the Troubled Asset Relief Program (<1%).

The combination of decreased revenues and increased spending has caused the deficit to grow to levels not seen since World War II. Since the four-year surplus the United States experienced from 1998 to 2001, a deficit has been incurred each year. As the Bush tax cuts expire, we can expect to see an increase in government revenues. Spending will steadily increase throughout the next decade as the federal government funds significant growth in Social Security, Medicare and Medicaid.

In order to understand why the federal government usually operates under a deficit, and to see why the debt has grown so large, one must take a larger look at the history of spending. Over the past four decades, mandatory spending has continued to claim a larger share of the federal budget. In 1962, mandatory spending made up about one-fourth of federal spending; now it makes up over half. The largest mandatory program is Social Security, which accounts for about one-third of mandatory spending. This program is expected to grow as the baby-boomers continue to age and retire, and is estimated to rise from using 4.8% of GDP in 2010 to 6.0% in 2035. Similarly, Medicare and Medicaid outlays are projected to rise to 16.7% of GDP.

According to the CBO, the deficit will remain above $1 trillion in 2011 and 2012 (9.8% of projected GDP in 2011, and 7.0% in 2012). However, it is expected to decrease drastically in 2013 due to the expiration of the Bush tax cuts, which will lead to an increase in government revenues. Spending will steadily increase throughout the next decade as the government funds significant growth in Social Security, Medicare and Medicaid. In 2013, the deficit is projected to be 10.0% of the GDP. In 2010, the deficit amounted to 8.9% of GDP.

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rise from 5.3% in 2010 to as much as 10.0% of GDP in 2035.\textsuperscript{12}

In addition to Social Security, Medicare and Medicaid, mandatory spending as a whole is expected to increase throughout the next decade. This will contribute to continued deficit spending, which according to the CBO, will increase the national debt by more than $8 trillion from 2011 to 2021. President Obama and Congress are currently negotiating policies that would decrease deficit spending and the projected rise of the debt. These policies range in cutting the deficit spending from around $2 to $4 trillion over the next decade. If these policies are implemented, the national debt held by the public should rise to around $14 or $16 trillion, rather than the expected $18 trillion.

DEBT CEILING

Since the Second Liberty Loan Act placed a statutory limit on the amount of federal debt the U.S. government could incur in 1918, debt limit laws have evolved. Originally the laws allocated specific and temporary borrowing authority, but over time, they have increasingly delegated more discretion to the Treasury. However, Congress continues to assert its constitutional prerogative to place ceilings on the overall government debt, for while the Constitution places the power of the purse with Congress, it is the Treasury that oversees borrowing and debt issuance. Without debt limit legislation, Congress would cede more of its control over how the federal government spends to the executive branch.

When the federal debt nears its legal limit, the Treasury Department is prevented from financing federal activities or meeting government obligations beyond those that can be funded with current cash flow. When this has occurred, Congress has raised the debt limit to accommodate further borrowing. Currently, the President and Congress are involved in a heated debate over the status of the debt ceiling. This is often a contentious issue when it is raised, which is actually quite often. In the last decade alone, the debt ceiling has been raised ten times.\textsuperscript{13}

REFORM OPTIONS

In 2010, the Congressional Research Service (CRS) published a report that outlined several reform options that could reduce the reliance on deficits and eventually reduce the federal debt. Utah Foundation does not endorse nor oppose any of these options; instead, they are explained here so that readers can have an understanding of how Congress may address the debt issue. The two main options are quite straightforward: reducing benefits and raising taxes.

According to CRS, changes in the benefit calculations could reduce Social Security outlays. For example, if initial benefits were indexed to price inflation instead of wage growth, outlays would fall significantly in the long run. In so doing, benefits would still rise in nominal terms, but the replacement rate of benefits compared to wages would fall. The advantage would be that as the spread between wages and prices grows, the savings to the government would rise over time.\textsuperscript{14} The CBO estimates that a proposal such as this could reduce outlays under current policy from 5.8% of GDP in 2050, to 4.1% of GDP.

Another proposal is to reduce the long-term growth in Medicare and Medicaid spending. This reduction in costs could come through the demand side or the supply side of the market. Demand could be reduced by shifting Medicare costs to the beneficiaries and away from government. By raising the deductibles and co-insurance rates, outlays could be reduced. However, this is dependent on the current rules and policies governing Medicare and Medicaid remaining stable, which is difficult to predict. On the supply side of the market, spending could be reduced by restricting the medical services Medicare and Medicaid will cover. The consequence of this would be that medical spending would cease or be shifted to private spending and private insurance. Despite any best effort by government, many economists doubt that excess cost growth could be reduced in Medicare and Medicaid without a reduction in private health care spending as well.\textsuperscript{15}

Rather than, or in combination with, reducing spending, Congress could increase taxes. A projected increase of tax revenues of 1.2% of GDP by 2050 would be required to maintain a pay-as-you-go system with Social Security. To place this in perspective, tax revenues increased by 2.5% of GDP between 1993 and 1999 after the Clinton tax increases. A larger increase would be needed to keep Medicare and Medicaid sustainable, as net spending on these projects is expected to increase to 7.8% of GDP by 2050. To cover this increase, taxes would need to increase by 2% of GDP by 2050.\textsuperscript{16} The country may experience a change in tax rates if the Bush Tax Cuts expire in December, 2012. Tax rates will revert from their current levels, which range from 10 to 35%, to the 2001 levels of 15 to 39.6%.\textsuperscript{17} CBO estimates that the extension of the Bush Tax cuts will reduce revenue by $423 billion in 2012. In 2013 as the tax cuts begin to expire, revenues will increase by about $300 billion, with an additional increase of $125 billion in 2014.\textsuperscript{18}

ENDNOTES

5 What is counted as government revenues and outlays depends on the presentation of the federal budget. For the past several decades, the focus...
of debates about the federal budget deficit or surplus has been on the consolidated budget. The consolidated budget, also referred to as the unified budget, consists of the two main types of funds: federal funds and trust funds. Federal funds comprise general government receipts not earmarked for any specific government activity. Trust funds are designated by law to a particular purpose. For example, the Hospital Insurance trust funds are earmarked to Medicare Part A benefits. The consolidated budget represents a comprehensive picture of the federal government’s financial activities.

6 United States Constitution, Article I, Section 8.
7 United States Constitution, Amendment XIV, Section 4.
8 Part of the debt, including some long-term bonds and savings bonds, was not available for redemption during CBO’s 10-year projection period. Therefore, in any given year, some debt would have remained outstanding and incur interest costs, regardless of the size of the surplus.
11 Congressional Budget Office, “Preliminary Analysis of the President’s Budget for 2012,” March 18, 2011.
14 Labonte, 9.
15 Ibid., 21.
16 Ibid., 18.

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