Chapter One
Understanding What's Driving the Annual Deficit

By Lawrence J. Haas

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At first blush, the problem of growing federal budget deficits seems straightforward to fix. The government is spending more than it is collecting in revenue, and policymakers must close the gap.

Beneath that view, however, is a far more complex reality. The huge and potentially catastrophic deficits we will face in the coming years reflect more than half a century of monumental change in economic philosophy, federal policy, public expectations, and demographics. Together, they have brought us to a point at which we—the American people and our leaders—want far more benefits and services from our government than we are willing to pay for.

We cannot easily fix this problem. We can't grow our way out of it through higher revenues generated by a booming economy because that would require the economy to grow far faster, and for far longer, than it has in modern times—which most economists believe is unrealistic. We can't solve the problem by cutting waste, fraud, and abuse, because the problem is simply too big. Instead, we must make tough decisions about what we want government to do and how we will pay for it.

Changing Public Views of Government

Federal deficits are nothing new in America, but their cause, size, and frequency have changed dramatically in recent decades.

Until the early 1930s, Washington ran deficits mainly for one of two reasons: the economy was weak or the nation was at war. Once the economy recovered (boosting revenues) or the war ended (reducing military spending), the government ran surpluses that repaid much of the debt of the previous period.[1] From 1792 to 1930, the government ran 46 deficits, offset by 93 surpluses.[2]

Political leaders and economists of that period viewed balanced budgets as morally right and economically beneficial. Even during the early years of the Great Depression, President Herbert Hoover tried to balance the budget and Franklin Roosevelt promised to do so when he ran for President in 1932.

The Depression, however, brought two landmark changes to federal budget-making.

First, it markedly changed public views about government. Americans demanded action to address the widespread hardship and FDR scrapped his balanced-budget promise and launched the New Deal, dramatically expanding government. Spending, which totaled just three percent of the economy in 1930 (as measured by Gross Domestic Product), rose to 11 percent of GDP by 1934 and totaled at least eight percent for the rest of the decade.

Second, Keynesian economics rose to challenge the orthodoxy of budget balancing. Enunciating a philosophy that would come to dominate economic thinking by mid-century, John Maynard Keynes argued that governments could and should run deficits to soften the impact of recessions and rejuvenate weak economies.[3]

All Eyes on Washington

In ensuing decades, government grew larger and assumed more functions. The President's Cabinet, which numbered eight departments through 1952, added Health, Education, and Welfare (later renamed Health and Human Services) in 1953, Housing and Urban Development in 1965, Transportation in 1966, Energy in 1967, Education in 1979, Veterans Affairs in 1987, and Homeland Security in 2002. Some agencies, such as the Environmental Protection Agency, have enjoyed independent Cabinet status under recent Presidents.[4]

To oversee the new federal functions, Congress established new committees and subcommittees after World War II and greatly expanded committee staffs.[5] Meanwhile, more private interests (big and small business, teachers, farmers, and so on) set up shop in Washington in the form of trade associations, interest groups, think tanks, and other entities. To help achieve their public policy goals, they hired from among the growing legion of lobbyists.

To a great extent, power in Washington derives from the size of the budget one oversees. On any given issue (e.g., education), the executive department, congressional committee, and private interest groups have every incentive to expand their programs, leading to more federal spending (or more tax breaks). These sectors work together in what political scientists call iron triangles.[6]

The proof is in the pudding of federal spending. Spending averaged less than 18 percent of GDP in the 1950s. But, spending rose to an average of 20 percent in the 1970s, nearly 21 percent in the 1990s, and, after falling earlier this century, to about 25 percent in the last few years. Revenues rose at a slower rate, which explains why deficits grew.[7]

The larger and more persistent deficits since World War II showcased the growing mismatch between what Americans wanted and what they would pay for. Replacing the earlier pattern of surpluses following deficits, deficits appeared during recession *and* prosperity, war *and* peace. Since 1945, Washington has run surpluses just 12 times.

Entitlements Take Over

Notably, spending has been increasingly dominated by entitlements, under which people receive benefits automatically based on age, income, or other criteria. Entitlements remain in effect unless Congress enacts laws to change them—distinguishing them from discretionary spending funded by appropriations bills that the President and Congress must enact each year for defense and domestic programs (e.g., research, law enforcement).

The major government entitlements are Social Security, created in 1935 to provide federally funded pensions; Medicare, created in 1965 to provide health insurance for senior citizens; and Medicaid, also created in 1965, (for which Washington shares costs with the states) to provide health insurance for the poor.

As they created new entitlements, the President and Congress expanded the ones already in place, so that entitlements increasingly provided more generous benefits to more eligible people. To Social Security, policymakers added disability insurance in the 1950s, Supplemental Security Income in the 1970s, and automatic cost-of-living adjustments starting in 1975. To Medicare, they added prescription drug coverage in 2003.[8]

Consequently, entitlements grew much faster than discretionary programs. Entitlements soared from just over 30 percent of spending in the early 1960s to 58 percent by 2010, while discretionary programs shrunk from 68 percent of spending in the early 1960s to 39 percent in 2010.

The more people who receive entitlement benefits, the greater the number of constituents who mobilize to protect them. To be sure, policymakers have reduced entitlements on occasion—for example, in 1983, when they pared future Social Security benefits to rescue the program from potential bankruptcy, and in numerous years when they cut reimbursements for health care providers under Medicare and Medicaid. But the growth in benefits and in eligible recipients has far outstripped the occasional efforts to rein in costs.

Meanwhile, a parallel phenomenon has unfolded on the tax side. There, policymakers have allocated an ever-growing array of deductions, credits, and other write-offs (known collectively as tax expenditures), enabling eligible individuals and corporations to reduce their annual tax liability. Tax expenditures, which (like entitlements) remain in effect unless policymakers enact laws to change them, now cost the federal government an estimated $1.3 trillion in lost revenue each year.[9]

Policymakers often dismiss tax expenditures as loopholes, but the costliest among them are about a dozen that provide tax benefits for tens of millions of households, making them every bit as important to many Americans as Social Security, Medicare, and Medicaid. They include the tax-free treatment of employer-provided health care; the home mortgage interest deduction; deductions for charitable contributions; and write-offs for capital gains, 401(k) plans, and other investment earnings.[10]

As entitlements and tax expenditures grow, simultaneously raising spending and draining revenues, deficits naturally balloon.

Driving the Deficit

To be sure, no one category of spending or revenues fully explains the deficit in any one year.

Huge deficits in recent years were driven largely by the deep recession (which severely drained revenues) and costly measures that policymakers enacted in late 2008 to stabilize the financial system (the TARP bailout bill) and in early 2009 to revive the economy (the stimulus bill). Exacerbating the problem were huge tax cuts in 2001 and 2003, the 2003 addition of prescription drug coverage to Medicare, and military operations in Afghanistan and Iraq—none of them financed through either tax hikes or spending cuts.

That largely explains why the deficit, which totaled $459 billion and 3.2 percent of GDP in 2008, soared to $1.4 trillion and 10 percent of GDP a year later and has remained close to that level in the last two years. Those deficits will naturally fall as the economy improves, the bailouts and stimulus measures expire, and overseas military operations wind down.

The problem is what comes next.

Under current policies and making reasonable assumptions about how the economy will perform, deficits and debt will soar in coming decades, according to the nonpartisan Congressional Budget Office (CBO). Annual deficits will hit 15 percent of GDP in 2035, while debt will top 100 percent by 2021 and reach nearly 190 percent by 2035.[11] The problem continues to worsen thereafter.

While revenues will grow from current levels in the future, spending will grow much faster for two main reasons: Americans are getting older and per-person health care costs are continuing to rise rapidly—not only faster than overall inflation but, in fact, faster than the economy is growing.

These two factors feed off one another. CBO projects that the retirement of baby boomers (those born between 1946 and 1964) will increase the share of the population aged 65 and older from today's 13 percent to 20 percent in 2035. That alone will greatly boost the ranks and swell the budgets of Social Security and Medicare. The swift rise in per-person health care costs will further swell the budgets of Medicare and Medicaid.

Consequently, Medicare and Medicaid (along with the Children's Health Insurance Program and insurance subsidies under health reform) will grow from today's 5.6 percent of GDP to between nine and 10 percent by 2035. Social Security will grow from nearly five percent to about six percent in the 2030s.

In essence, the fiscal chickens are coming home to roost. Decades of rising public demands on government, growing entitlements, and iron triangles of executive departments, congressional committees, and private interests—now combined with the aging of America, soaring health care costs, and inadequate revenues—have fueled prospects of exploding deficits and debt in the coming decades.

Looking ahead, the decisions that we will make about health care, Social Security, and taxes will determine whether we free ourselves from, or are increasingly dogged by, pools of red ink.

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Notes

1. The term "debt" refers to debt held by the public—that is, by individuals, corporations, state or local governments, foreign governments, and other entities—as distinct from gross federal debt, which also includes debt that the government owes to itself through various trust funds.

2. John Steele Gordon, *Hamilton's Blessing: The Extraordinary Life and Times of Our National Debt* (New York: Walker & Company, 2010), p. 113. See also James D. Savage, *Balanced Budgets and American Politics* (Ithaca: Cornell University Press), 1988.

3. In his seminal work of 1936, *The General Theory of Employment, Interest, and Money*, and elsewhere.

4. Thomas A. Garrett and Russell M. Rhine, "On the Size and Growth of Government," *Federal Reserve Bank of St. Louis Review*, January/February 2006.

5. Michael Welsh, "An Overview of the Development of U.S. Congressional Committees," Law Librarians' Society of Washington, D.C., Inc. (http://www.llsdc.org/attachments/wysiwyg/544/Cong-Cmte-Overview.pdf)

6. Dr. Paul M. Johnson, "Iron Triangles," in *A Glossary of Political Economy Terms.* (http://www.auburn.edu/~johnspm/gloss/iron_triangles)

7. *Historical Tables*, Budget of the United States Government, Fiscal Year 2012.

8. "Historical Background and Development of Social Security," Social Security Online. (http://www.socialsecurity.gov/history/briefhistory3.html)

9. Donald B. Marron, "How Large Are Tax Expenditures?" in "Tax Facts," a biweekly column in *Tax Notes,* Tax Policy Center, March 28, 2011, p. 1597. (http://taxpolicycenter.org/UploadedPDF/1001526-Expenditure-Estimates.pdf)

10. "Federal Receipts," *Analytical Perspectives*, Budget of the United States Government, Fiscal Year 2012.

11. Congressional Budget Office, CBO's 2011 *Long-term Budget Outlook,* June 2011. CBO's projections of long-term deficits and debt and its explanation of the forces that are driving them reflect the thinking of mainstream budget experts in and out of government.