A Citizen's Guide to the Federal Budget

Budget of the United States Government

Fiscal Year 2001

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4. The Budget Surplus and Fiscal Discipline

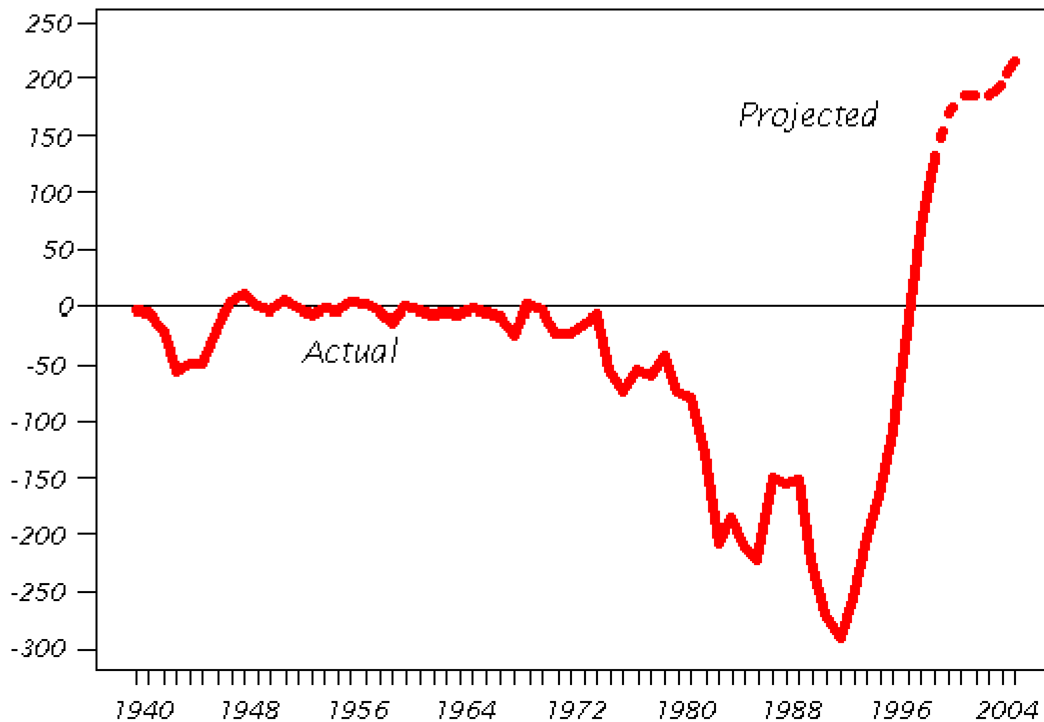
In 1998, the Federal budget reported its first surplus ($69 billion) since 1969. In 1999, the surplus nearly doubled to $124 billion. As a result of these surpluses, Federal debt held by the public has been reduced from $3.8 trillion at the end of 1997 to $3.6 trillion at the end of 1999. With continued prudent fiscal policies, the budget can remain in surplus for many years. Under the President's budget proposals, the Federal debt held by the public would be fully paid back by 2013.

Put simply, a surplus occurs when revenues exceed spending in any year--just as a deficit occurs when spending exceeds revenues. Generally, to finance past deficits, the Treasury has borrowed money. With certain exceptions, the *debt* is the sum total of our deficits, minus our surpluses, over the years.

The Government incurred its first deficit in 1792, and it generated 70 annual deficits between 1900 and 1997.

Chart 4-1 provides the history of budget surplus and deficits since 1940.

Chart 4-1. Past and Future Budget Deficits or Surplus



Deficits began increasing dramatically in the 1980s, but have now been reversed.

For most of the Nation's history, deficits were the result of either wars or recessions. Wars necessitated major increases in military spending, while recessions reduced Federal tax revenues from businesses and individuals.

The Government generated deficits during the War of 1812, the recession of 1837, the Civil War, the depression of the 1890s, and World War I. Once the war ended or the economy began to grow, the Government followed its deficits with budget surpluses, with which it paid down the debt.

Deficits returned in 1931 and remained for the rest of the decade--due to the Great Depression and the spending associated with President Roosevelt's New Deal. Then, World War II forced the Nation to spend unprecedented amounts on defense and to incur corresponding unprecedented deficits. Since then--with Democratic and Republican Presidents, Democratic and Republican Congresses--the Government has balanced its books only ten times, most recently last year.

Nevertheless, the deficits before 1981 paled in comparison to what followed. That year, the Government cut income tax rates and greatly increased defense spending, but it did not cut non-defense programs enough to make up the difference. Also, the recession of the early 1980s reduced

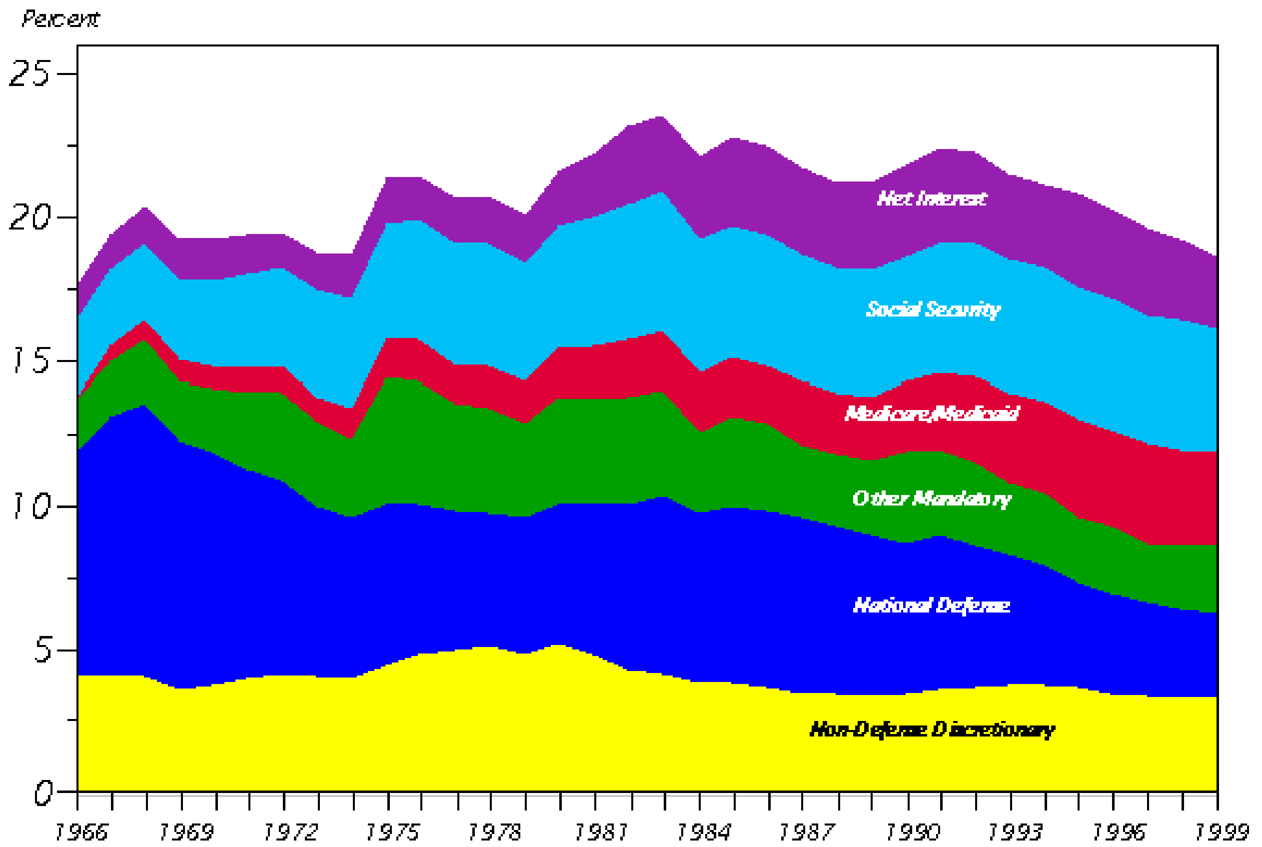
Federal revenues, increased Federal outlays for unemployment insurance and similar programs that are closely tied to economic conditions, and forced the Government to pay interest on more national debt at a time when interest rates were high. As a result, the deficit soared.

Why have we been able to move from deficit to balance? Because spending growth has been restrained. Outlays are growing slower than revenues.

Revenues have stayed relatively constant, at around 16 to 20 percent of GDP, since the 1960s. In that time, however, outlays grew from about 17 percent of GDP in 1965 to nearly 24 percent in 1983 before falling below 19 percent today.

Since 1983, spending has been reduced or held constant as a percent of GDP across a wide variety of programs. The most significant reduction has occurred in discretionary spending, which has fallen from 10.3 percent to 6.3 percent in 1999. Combined spending on social security and net interest has remained roughly constant at about $7\frac{1}{2}$ percent of GDP from 1983 to 1997. However, the debt reduction of the last two years has brought this spending down to 6.7 percent of GDP in 1999. A similar path has been followed in the rest of mandatory spending in total, but only because the growth in Medicare and Medicaid has been offset by declines in other mandatory spending (see Chart 4–2).

Chart 4-2. Outlays as a Percent of GDP



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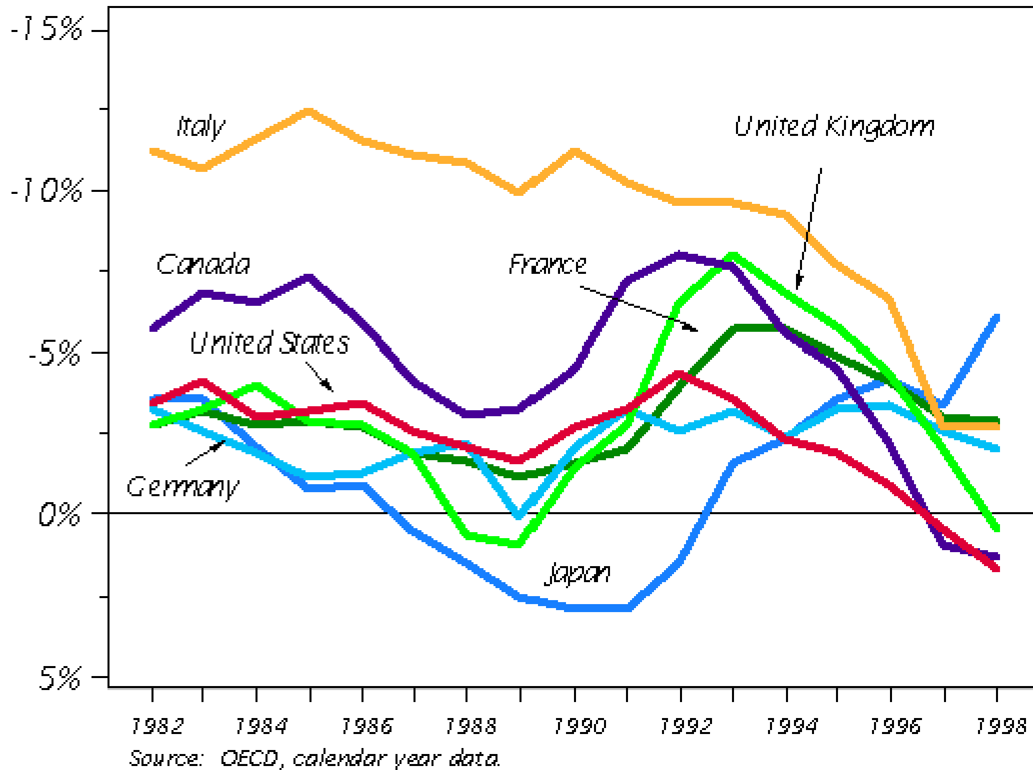
Between 1966 and 1999, spending on Social Security, Medicare and Medicaid, and interest as a percentage of GDP grew, while spending on defense fell.

Why a Budget Surplus is Important

Chart 4-3. Total Government Surplus or Deficit as a Percent of GDP

Surplus (+)/deficit (-) in billions of dollars



Of the seven nations shown above, only the United States, Canada, and the United Kingdom eliminated their total government budget deficits in 1997 or 1998.

As Chart 4–3 illustrates, this Nation has a good record when compared to the recent history of the six other major developed economies. (To make accurate comparisons with the governments of other nations, the U.S. data include the activities of State and local governments.)

Should we worry about the possibility of a return to budget deficits?

The 2001 Budget forecasts surplus for decades to come, if we maintain the policy of fiscal discipline and strategic investments in the American people.

We must do all we can to keep the days of deficits in the past. Budget deficits force the Government to borrow money in the private capital markets. That borrowing competes with (1) borrowing by businesses that want to build factories and machines that make workers more productive and raise incomes, and (2) borrowing by families who hope to buy new homes, cars, and other goods. The competition for funds tends to produce higher interest rates.

Deficits increase the Federal debt and, with it, the Government's obligation to pay interest. The more it must pay in interest, the less it has available to spend on education, law enforcement, and other important services, or the more it must collect in taxes--forever after. As recently as 1997, the Government spent over 15 percent of its budget to pay interest, in contrast to a projected 11 percent for 2001. Continuing surplus will reduce these interest payments further in future years.

In the end, the surplus is a decision about our future. We can provide a solid foundation for future generations, just as parents try to do within a family. For a Nation, this means a strong economy and low interest rates and debt. Alternatively, we can generate large deficits and debt for those who come after us.

Surplus and Debt

If the Government incurs a surplus, it generally repays debt held by the public.

Table 4–1 summarizes the relationship between the budget surplus and the repayment of Federal debt.

Table 4-1. Federal Government Financing and Debt

(in billions of dollars)

	1999	Estimate					
	Actual	2000	2001	2002	2003	2004	2005
Federal Government financing:							
Unified budget surplus	124	167	184	186	185	195	215
Social Security solvency lock-box:							
Off-budget	124	148	160	172	184	195	214
Medicare solvency	.....	.....	15	13	.....	.....	.....
On-budget	1	19	9	1	*	*	2
Other means of financing	−36	−9	−13	−15	−14	−12	−12
Repayment of debt held by the public	89	157	171	171	170	183	203
Federal Government debt::							
Debt subject to legal limit	5,568	5,648	5,732	5,819	5,912	5,999	6,086
Gross Federal debt	5,606	5,686	5,769	5,855	5,947	6,034	6,118
Debt held by government accounts	1,973	2,210	2,464	2,721	2,984	3,253	3,541
Debt held by the public	3,633	3,476	3,305	3,134	2,963	2,781	2,578

* $500 million or less.

Note: Numbers may not add to the totals because of rounding.

Note: The stub title for the final line in Table 4.1 has been corrected to read "Debt held by the public".

Federal borrowing involves the sale, to the public, of notes and bonds of varying sizes and time periods until maturity. The cumulative amount of borrowing from the public--i.e., the debt held by the public--is the most important measure of Federal debt because it is what the Government has borrowed in the private markets over the years, and it determines how much the Government pays in interest to the public.

Debt held by the public was $3.6 trillion at the end of 1999--roughly the net effect of deficits and surplus over the last 200 years. Debt held by the public does not include debt the Government owes itself--the total of all trust fund surpluses and deficits over the years, like the Social Security surplus, which the law says must be invested in Federal securities.

Because the large budget deficit has been turned into a surplus, the debt held by the public was reduced in the last two years for the first time since 1969.

The sum of debt held by the public and debt the Government owes itself is called Gross Federal Debt. At the end of 1999, it totaled $5.6 trillion.

Another measure of Federal debt is debt subject to legal limit, which is similar to Gross Federal Debt. When the Government reaches the limit, it loses its authority to borrow more to finance its spending; then, the President and Congress must enact a law to increase the limit. Because the budget has returned to surplus and publicly held debt is being reduced, there will be no need to increase the statutory limit in 2001.

The Government's ability to finance its debt is tied to the size and strength of the economy, or GDP. Debt held by the public was less than 40 percent of GDP at the end of 1999. As a percentage of GDP, debt held by the public was highest at the end of World War II, at 109 percent, then fell to 24 percent in 1974 before gradually rising to a peak of over 49 percent in the middle 1990s.

That decline, from 109 to 24 percent, occurred because the economy grew faster than the debt accumulated; debt held by the public rose from $242 billion to $344 billion in those years, but the economy grew faster.

Individuals and institutions in the United States hold about two-thirds of debt held by the public. The rest is held in foreign countries.

Returning the Budget to Surplus

Ever since the deficit soared in the early 1980s, successive Presidents and Congresses have tried to cut it. Until recently, they met with only limited success.

In the early 1980s, President Reagan and Congress agreed on a large tax cut, but could not agree about cutting spending; the President wanted to cut domestic spending more than Congress, while Congress sought fewer defense funds than the President wanted. They wound up spending more on domestic programs than the President wanted, and more on defense than Congress wanted. At the same time, a recession led to more spending to aid those affected by the recession, and reductions in tax revenues due to lower incomes and corporate profits.

By 1985, both sides were ready for drastic measures. That year, they enacted the Balanced Budget and Emergency Deficit Control Act (GRH). It set annual deficit targets for five years, declining to a balanced budget in 1991. If necessary, GRH required across-the-board cuts in programs to comply with the deficit targets.

Faced with the prospect of huge spending cuts in 1987, however, the President and Congress amended the law, postponing a balanced budget until 1993. The President and Congress never achieved those revised targets, in part because of the extraordinary costs of returning the Nation's savings and loan industry to a sound financial footing.

By 1990, President Bush and Congress enacted spending cuts and tax increases that were designed to cut the accumulated deficits by about $500 billion over five years. They also enacted the Budget Enforcement Act (BEA)--rather than set annual deficit targets. The BEA was designed to limit discretionary spending while ensuring that any new entitlement programs or tax cuts did not make the deficit worse.

First, the BEA set annual limits on total discretionary spending for defense, international affairs, and domestic programs. Second, it created "pay-as-you-go" rules for entitlements and taxes: those who proposed new spending on entitlements or lower taxes were forced to offset the costs by cutting other entitlements or raising other taxes.

For what it was designed to do, the law worked. It did, in fact, limit discretionary spending and force proponents of new entitlements and tax cuts to find ways to finance them. But the deficit, which Government and private experts said would fall, actually rose.

Why? Because the recession of the early 1990s reduced individual and corporate tax revenues and increased spending that is tied to economic fluctuations. Federal health care spending also continued to grow rapidly.

In 1993, President Clinton and the Congress made another effort to cut the deficit. They enacted a five-year deficit reduction package of spending cuts and higher revenues. The law was designed to cut the accumulated deficits from 1994 to 1998 by about $500 billion. The new law extended the limits on discretionary spending and the "pay-as-you-go" rules.

Although the 1993 plan exceeded all expectations in reducing the deficit, the task of reaching balance would require one final push. That would come with the historic 1997 Balanced Budget Act (BBA). Originally designed to balance the budget by 2002, the BBA provided for $247 billion in savings over five years. It also extended the solvency of Medicare's trust fund for at least 10 years while providing for the largest investment in higher education since the G.I. Bill in 1945, the largest investment in children's health care since the creation of Medicaid in 1965, and a $500-per-child tax credit for about 27 million working families.

Clearly, the President's deficit reduction efforts have paid off. The deficit fell from $290 billion in 1992 to a surplus of $124 billion in 1999.

The President is now proposing that Social Security be protected and the solvency of its trust funds be extended. With enactment of these reforms, as well as strengthening of Medicare, additional resources would be made available for national needs, including health care initiatives and a tax cut. The next chapter describes the President's plans for achieving that goal.

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