3-25-1983

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COOPERATIVE EXTENSION SERVICE

Economics Newsletter

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No. 194 March 25, 1983

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We experienced record inflation 3 years ago, record interest rates 2 years ago, recession last year, and now the inklings of an economic recovery. However, there is still a lot of uncertainty surrounding the probable length and strength of the recovery and the appropriate response of government. Because of the federal government's role in managing the economy, many people have become interested in studying the trends in the federal budget and public debt. Where do the federal revenue dollars come from? Where are they spent? How much is borrowed? How big is the public debt? What are the budget policy options? This newsletter is designed to answer these critical questions.

Where Does Federal Revenue Come From?

The mix of revenues used to finance the federal government is included in Table 1. Two major trends are evident in comparing 1965, 1975, and 1982. Individual income taxes and social insurance payroll deductions have increased as a proportion of total revenue collections. However, the share of total revenues coming from corporate income taxes and excise taxes (i.e., selective sales taxes) have declined by half. These trends are attributable primarily to legislated changes in the relative tax rates, to a declining share of corporate profits in national income (from 14% in 1965 to 7% in 1982), and to an increasing share of employee compensation in national income (from 69% in 1965 to 76% in 1982).

Table 1. The Federal Revenue Mix, 1965-1982

Source of Revenue	Percent of Total Federal Revenue 1965	1975	1980	1982
Individual Income Taxes	41.8	43.9	47.2	48.3
Corporate Income Taxes	21.8	14.6	12.5	8.0
Social Insurance	19.1	30.3	30.5	32.6
Excise Taxes	12.5	5.9	4.7	5.9
All others	4.9	5.4	5.0	5.3
Total Revenue	100.0	100.0	100.0	100.0

Source: Congressional Budget Office, Feb. 1983.

Where Does the Federal Spending Go?

The federal spending mix is included in Table 2. As a percent of all federal spending, the defense category declined most sharply between 1965 and 1982. This decline started after WWII and continued after the Vietnam War until 1980. Since 1980, the defense share of total spending has increased slightly.

Table 2. The Federal Spending Mix, 1965-82

Category of Spending	Percent of Total Federal Spending 1965	1975	1980	1982
National Defense	40.1	26.4	23.6	25.7
Entitlements:				
Social Security	14.4	19.3	20.1	21.0
Medicare-Medicade	a	6.6	8.4	9.2
Farm Price Supports	2.3	0.2	0.5	1.6
All Other Entitlements[b]	12.2	20.5	17.6	15.5
Sub total	28.9	46.6	46.6	47.1
Non-Defense Discretionary Spending[c]	26.4	23.4	24.5	19.1
Net Interest[d]	7.3	7.2	9.1	11.6
Offsetting Receipts	-2.5	-3.5	-3.7	-3.7
Total Spending	100.0	100.0	100.0	100.0

[a] Predecessor program counted in other entitlements.

[b] Includes Aid to Families with Dependant Children, Federal Retirement, General Revenue Sharing, Food stamps, Supplemental Security Income, human services block grants, Guaranteed Student Loans, Veteran's Compensation and Pensions, Black Lung Compensation, Railroad Retirement and Federal unemployment compensation.

[c] Annually appropriated amounts that in large part represent ongoing operations of legislative, judicial, tax collecting , and administrative functions of government and all other grants not included in entitlements.

[d] Interest payments on the federal debt less interest received by trust funds.

Source: Congressional Budget Office, Feb. 1983.

Entitlements grew most rapidly between 1965 and 1982. These programs represent mandatory spending to cover benefits paid to all those who meet the eligibility criteria established by law.

The increase in entitlement spending is a result of two trends. First, we saw legislated expansion of programs such as social security, food stamps, medicare, medicaid, and revenue sharing in the early 1970's. Second, the proportion of older people in the population has been increasing and will continue to do so for the next 50 years.

How Much Does the Federal Government Borrow?

A deficit occurs when federal spending exceeds revenues. A budget deficit has occurred in every year since 1965 except 1969. The deficits also have grown even after inflation is accounted for. This occurred because spending increased from 18 to 24% of the Gross National Product (GNP) between 1965 and 1982 while federal revenues grew only from 18 to 20%. (GNP is the value of all goods and services produced annually in the economy.) As a result, the deficits have risen. In 1965, the deficit represented 1.4% of the budget and 0.2% of GNP. In 1982, the deficit accounted for 15.2% of the budget and 3.6% of GNP. The Congressional Budget Office projects that the current fiscal year's deficit will represent 24% of the total budget and 6.1% of GNP.

Table 3. The Federal Deficit in Perspective, 1965-83

Deficit Data	1965	1975	1980	1982	1983P
Unified Deficit (bil dol)	-1.6	-45.2	-59.6	-110.6	-194.0
Percent of Budget (%)	1.4	13.9	10.3	15.2	24.1
Percent of GNP (%)	0.2	2.9	2.3	3.6	6.1

PProjected by Congressional Budget Office, Feb. 1983.

Source: Economic Report of the President, 1983; Congressional Budget Office, 1983.

How Large is the Federal Debt?

The federal debt is simply the accumulation of federal budget deficits. Since 1965, the federal debt as a percent of GNP declined until 1974. Since 1974 it has been rising slightly. This trend is expected to continue for the current fiscal year. However, we must remember that these figures only account for the amount which the federal government has borrowed. If we offset federal borrowings by the amount which the government has loaned out, then our public debt is cut approximately in half.

Table 4. Federal Debt Statistics, 1965-83

Debt Statistics	1965	1975	1980	1982	1983P
Federal Debt (bil dol)	323.2	544.1	914.3	1147.0	1383.7
Debt as a Percent of Revenue (%)	276.7	194.9	176.8	185.7	231.6
Debt of a percent of GNP (%)	49.0	36.8	35.5	37.8	43.3

PProjected Council of Economic Advisors, Feb. 1983.

Source: Budget of the U.S. Government FY 1984, Jan. 1983.

What Are the Budgetary Policy Options?

In general, public decision-makers adopt one of three budgetary strategies. (1) Save now--buy later. (2) Pay as you go. (3) Buy now--pay later. Under the save now--buy later strategy, current taxpayers pay for benefits received by future generations of taxpayers. Presently most government units do not employ this strategy. However, a historical example is the land grant system for schools and colleges. In this case, current generations benefit from spending foregone by the past generations of taxpayers.

Most state and local units of government employ the pay as you go strategy in their operating budgets. Here, current spending cannot exceed current revenues. As a result the current generation of taxpayers foots the bill but also receives the benefits of most government spending.

The buy now--pay later strategy has been employed by the federal government since the 1960's and periodically before then. This approach shifts part of the current spending bill to future generations of taxpayers. As we increase deficits, not only does the public debt increase, but annual interest payments on the debt increase. In 1982, net interest payments accounted for 11% of the total federal budget. However, if we exclude interest earnings on trust funds, the actual interest payment on the federal debt accounted for 16% of the budget. Therefore this strategy results in debt that is paid off in future years and interest payments that reduce future spending potential.

Some analysts suggest that the impact of the public debt depends on inflation. During the inflationary 1960's and 70's, the public debt was growing in actual dollars but was declining after the adjustment for inflation. Thus, it is said that we can simply pay off the debt with inflated dollars. However, if we look at the whole picture, inflationary monetary and fiscal policies subsidize credit for the current generation but shift disinflationary recession adjustments to a future time period. So--regardless of inflation, the buy now--pay later strategy shifts part of the government spending bill to a future generation of taxpayers.

The Present Dilemma

Because of the recession, current revenues have actually declined from last year. More people are unemployed and therefore are receiving entitlement benefits. So, there is less interest in balancing the federal budget for the coming year than in balancing the budget in future years.

The Congressional Budget Office (CBO) projections show federal deficits will be increasing rather than decreasing in future years. Their February 1983 projections are based on a continuation of current policy under conditions of economic recovey. The CBO projection for the 1983 deficit is $194 billion, but deficits in 1984 to 1988 are projected to be in the $200 to $250 billion range assuming recovery.

Uncle Sam borrows from the same credit markets as business and consumers. In 1979 before tight money policy, federal borrowing accounted for less than 20% of total funds raised in the U.S. credit markets. Last year federal borrowing accounted for more than 30%. A federal deficit of $250 billion would account for about half of total funds raised presently in the credit markets. So, under a tight money policy, increased federal borrowing is likely to increase interest rates, crowd out private borrowers, and potentially choke off the recovery.

Alternatively we could expand the money supply at a much faster rate to accommodate the larger federal deficits while keeping interest rates down. Eventually, this approach would create another round of inflation.

As a result of this trade-off, continuing to keep inflation down will require some tough political choices in the federal budget. Lower deficits require higher taxes or lower spending on defense, entitlements, and/or other government operating and discretionary funds. And, if such tax hikes or spending cuts aren't partially targeted toward those with more ability to adjust financially, weaker consumption demand is more likely to stall the recovery.

Concluding Comment

If we are serious about reducing the federal deficits, there are three basic strategies available. The first approach is to place a lid or ceiling on the public debt. We've done this. Presently, the ceiling is simply raised when it's hit. So the debt lid becomes a sieve unless the voting rules are changed to require a larger majority.

A second approach is to limit annual deficits. Many people have proposed a constitutional amendment that increases the size of the voting majority required to pass a deficit except under national emergency conditions. By last year, 31 states had passed resolutions calling for a constitutional convention to do just that. Three more states are required to initiate such a process. Congress considered such a proposal last year. It passed the Senate but died in the House.

The third approach is to simply elect political decision-makers who place a higher priority on reduction in federal deficits than on reducing taxes or increasing national defense, entitlements and other spending.

In the final analysis, many people wonder if we really can reduce our deficits and pay off the national debt. After the Revolutionary War and War of 1812, the U.S. had a public debt that was nearly the same percent of GNP as today. It was paid off over a 30 year period. It took us 50 years to accumulate the current public debt. Maybe it would take us 50 years to pay it off, but the real question is: "Are we serious about doing so?"

Twenty-first Annual

Agri-Business Day

Thursday, April 7, 1983
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A special program of the
Economics Department
South Dakota State University
Brookings, South Dakota

Issued in furtherance of Cooperative Extension work, Acts of May 8 and June 30, 1914, in cooperation with the USDA, Hollis D. Hall, Director of Cooperative Extension Service, SDSU, Brookings. Educational programs and materials offered without regard to age, race, color, religion, sex, handicap or national origin. An Equal Opportunity Employer.

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U.S. Department of Agriculture
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