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The Revenue and Spending Mismatch

How the Widening Gap Between Spending and Income Has Produced Fiscal Turmoil

Michael Linden and Michael Ettlinger February 1, 2010

Only 60 percent of the money spent by the federal government in 2009 was paid for. The other 40 percent was covered by borrowed funds. This is the lowest share of federal spending paid for by revenues—the taxes and fees collected by the federal government—since World War II. The next lowest revenue-to-spending ratio, or RSR, was in 1983 when 74 percent of federal public spending was paid for.

If we leave out Social Security and Medicare—which have dedicated revenue sources—only half of the rest of the federal government's activities were paid for in 2009. To put that in perspective, the unpaid-for amount of the budget, which is the amount borrowed, was the equivalent of the entire defense budget, Medicaid, veteran's benefits, and all funding for the Department of Homeland Security and the Department of Health and Human Services combined.

It is not surprising that we didn't pay for much of what we spent in 2009, and that the RSR was therefore so low. Such is to be expected in the midst of the most significant economic downturn since the Great Depression. Revenues drop in any economic downturn as tax liabilities based on personal and corporate income plummet.

Of course, budget deficits come with the falling RSR, and the 2009 deficit hit a postwar high of 9.9 percent of the gross domestic product. But the biggest concern is not the unprecedented RSR and deficits in 2009. Deficits are a good thing during the peak of a recession. They inject borrowed money into the economy to jumpstart it and reverse the downward momentum. It was large deficits that brought us out of the Great Depression and are now playing a vital role in pulling us out of the Great Recession.

As the economy improves, so too will revenues, and the budget will start to creep toward balance. But there are deep structural flaws in the U.S. fiscal situation that can't be fixed by economic growth alone. Without action to increase revenues, reduce spending, or both, the RSR will be at historically low levels even after the end of the Great Recession, creating unsustainable deficits and debt.

The RSR and budget deficits

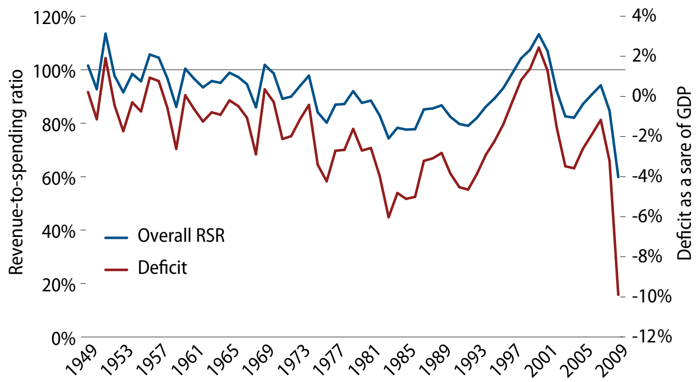
The relationship between the RSR and the overall budget deficit is simple and clear. Any budget that does not cover 100 percent of its spending with revenues will necessarily be in the red. An RSR of less than 100 percent indicates a budget deficit, an RSR of more than 100 percent indicates a surplus, and an RSR of exactly 100 percent means a budget in perfect balance with income exactly equal to spending.

The federal government has paid for an average of 92 percent of its total expenditures with revenues over the past 60 years. The RSR has, however, fluctuated over time with some periods enjoying a higher RSR and others a much lower one.

The overall RSR for the federal budget fluctuated from 1950 to 1974, between a high of 113 percent in 1951, and a low of 86 percent in 1959 and 1968. The overall RSR during those 25 years most often fell into the even narrower range between 90 percent and 100 percent, and as result the federal government ran only small deficits, averaging only 0.6 percent of GDP.

FIGURE 1

The revenue-to-spending ratio and budget deficits, 1949–2009



Source: Congressional Budget Office

The budget shifted onto somewhat weaker ground starting in 1975 when the RSR dropped below 85 percent for the first time since World War II. During the next 20 years, the RSR only climbed back over 90 percent once in 1979, and on average the federal government's revenues only paid for 83 percent of total spending. The federal deficits in this period were as a result significantly larger than during the previous quarter of the century, averaging more than 3.5 percent of GDP.

1983 was a low point for the RSR as it dipped to 74 percent, driven down by the massive tax cut passed in the previous year. The 1983 RSR was nearly 6 percentage points lower than at any point since 1950. The deficit grew accordingly in 1983 and set a new postwar high at 6 percent of GDP that was not matched until the Great Recession swamped the budget in 2009.

Ten years after reaching that new low, the federal budget's RSR came to a turning point and began to climb steadily, improving every year for eight straight years. The RSR surpassed 100 percent in 1998 for the first time since 1969, indicating the first budget surplus in nearly 30 years, and then hit its peak of 113 percent in 2000—the highest RSR in 50 years.

The extremely strong fiscal situation of 2000 did not last. Given that RSRs were at historic highs by the end of the 1990s, it is not completely surprising that there was a return to more "normal" levels. Yet the steep decline in the RSR that took place went far beyond merely returning to normalcy as the tax cuts of 2001 and 2003 took hold. The RSR dramatically dropped starting in 2001, falling 30 percentage points in just two years. These depths indicated a budget badly out of balance, and while there was some improvement over the next several years as income from the housing bubble boosted revenues, the onset of the Great Recession quickly reversed any progress and sent the RSR down into the historic depths we see today.

Looking ahead, the tax cuts' overhang, the costs of two unpaid wars, and rising costs due to health care prices and an aging population mean that annual RSRs will, without action, languish in the 80 percent range where they were prior to the recession. That would mean higher deficits with their attendant economic risks and more interest payments on rising debt eating into program spending.

The primary RSR and debt

There is one important variant to the overall RSR called the primary revenue-to-spending ratio, or the PRSR. Like the RSR, the PRSR is defined as total revenues as a percentage of expenditures. But the PRSR excludes payments of interest on the debt. The PRSR gives a picture of how much of the government's spending on its programs is covered by its income. The importance of this measure is that it tells us whether the government has enough revenue to cover its basic spending obligations.

A PRSR of less than 100 percent means that it does not have enough revenue to cover its basic spending obligations. A balanced primary budget, on the other hand, means that the government's fundamental activities are covered, even though no progress is being made to pay down accumulated debt. In other words, the total amount we owe isn't going down, but it isn't going up either.*

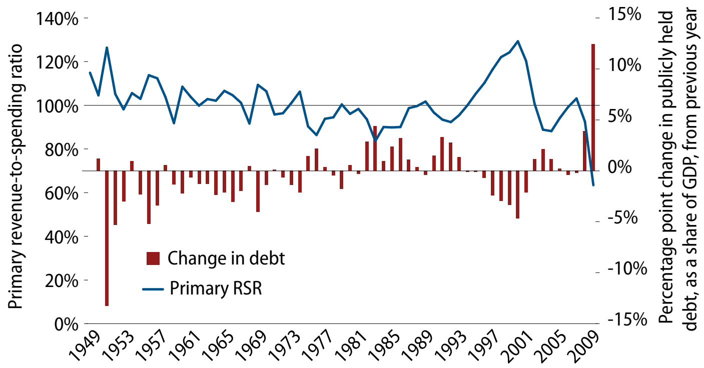
The federal government's PRSR—like the overall RSR—was at a historic low in 2009. Taxes and fees paid for less than 64 percent of total programmatic spending. A PRSR this low is of serious concern, because it is a very good indication that our nation's debt as a share of GDP is on the rise. As with deficits, our debt is also heading to historically high levels.

After the great expense of World War II, the United States' publicly held debt was at an all-time high of just under 109 percent of GDP. The debt-to-GDP ratio declined rather steadily over the next three decades as economic growth boomed and federal budget deficits were kept small, bottoming out in 1974 at 24 percent of GDP.

The debt-to-GDP ratio began to rise again starting in 1975, and the increase accelerated in 1982. Publicly held debt reached almost 50 percent of GDP by 1993, a level not seen in nearly 40 years. But the improving fiscal situation of the 1990s, culminating in surpluses at the end of the decade, led to debt declining steadily through 2001. Yet, a change in fiscal policies in 2001 reversed the trend, and the debt-to-GDP ratio crept back up. And more recently, the Great Recession had an enormous effect on debt levels. In 2009, publicly held debt as a share of GDP again surpassed 50 percent.

FIGURE 2

The primary revenue-to-spending ratio and year-over-year change in debt-to-GDP ratio



Source: Congressional Budget Office

The relationship between the PRSR and the change in debt-to-GDP has been very pronounced over the past 50 years. From 1960 forward, there were 22 individual years in which the PRSR exceeded 100 percent, and in all but one of those years, the debt-to-GDP ratio declined from the previous year.** The relationship between the PRSR and debt-to-GDP is clear: When primary balance is achieved, the debt burden stabilizes; when the PRSR falls, debt increases; and when the PRSR exceeds 100 percent, debt falls.

Unfortunately, with the PRSR now hitting new lows, our national debt will to continue to rise. We simply aren't paying for a high-enough percentage of our programmatic spending. In fact, a primary RSR this low indicates that we will have to keep borrowing just to pay for our essential costs. This is a recipe for an explosion in debt.

Conclusion

There isn't much mystery in the arithmetic of how the country got into its current fiscal situation. Revenues have been a lot lower than spending. This isn't a problem in the short run during a recession and incipient recovery. The economy is sick, and it's also out of work, so we need to borrow to bring it back to health. But at some point, actual income has got to once again get in line with spending.

As outlined in our report, "A Path to Balance," the first step should be achieving primary balance so we're not running up further debt. But we should be raising as much as we're spending once the economy is going strong again. Then we can get the debt down, so if the economy gets sick again, or some other great challenge emerges, we can borrow again if we have to.

Note: The benefits and drawbacks of using the RSR

There are several advantages to using the revenue-to-spending ratio in conjunction with other fiscal metrics. First, absolute measures of the size of a budget deficit can sometimes be misleading. Discovering that a budget deficit in a given year is expected to be $100 billion, for example, will often not convey much useful information on its own. Is $100 billion a lot or is it actually rather small? The answer to that question depends on a variety of other factors, including the overall size of the budget.

What's more, a $100 billion deficit in one year generally will not be of the same overall magnitude as a $100 billion deficit in a different year due to inflation. The RSR does not suffer from either of these problems. Because it is measured as a ratio of the two sides of the ledger, the RSR comes with built-in context. RSRs far below 100 percent mean the government is falling far short of paying its bills without borrowing, regardless of the absolute size of the budget. An RSR from one year is also directly comparable to an RSR from another year.

On the other hand, the revenue-to-spending ratio does not specifically convey how large a budget gap is with respect to the overall economy. This is an important shortcoming, because a society's ability to close that budget gap is directly related to its economic means. This being the case, measuring a deficit as a share of GDP is still the very best way to describe how much of an economic challenge a deficit or debt burden actually presents. The RSR, however, gives a better sense of how much will have to change in terms of revenues and spending to bring the budget more in line.

*Overall debt as a share of GDP can actually rise or fall even in years when the budget is in primary balance, depending on GDP growth and interest rates. However, the general relationship between primary balance and stabilized debt is quite strong and has been born out over the past 50 years.

** In the 1950s, this relationship was less robust. From 1950 to 1959, there were eight years in which the budget achieved primary balance, but the debt-to-GDP ratio declined in only five of these years.

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