The Federal Budget Deficit

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Introduction

The debate over the public debt is as old as the country. Alexander Hamilton established the framework for our national financial system in the first administration after the founding of the government under the Constitution in 1789. In the assumption of the debts incurred by the individual states during the Revolutionary War, Hamilton established the creditworthiness of the United States, thus forming the basis of the early economic growth of industry and financial institutions in the young republic. In the First Report on the Public Credit presented the House of Representatives in 1790, Hamilton viewed the debts incurred during the Revolution as "the price of liberty." Hamilton summed up the benefits of the public debt in the report by declaring it a "public blessing" (Swanson 1990). According to Chernow (2004), this unusual proclamation was often taken out of context and used by his critics to disparage Hamilton's efforts to build a strong central government. In the report Hamilton, gave unambiguous warnings that public debts should not become permanent debts, and that provision for systematic discipline in retiring the debt obligations is fundamental to establishing the "immortal" credit of a nation. In the current discourse over the federal budget deficit and growing national debt, critics continue to invoke Hamilton's blessing and his role as founder in the current budget debates.

Deficit spending and an accumulating public debt are widely recognized as being necessary in times of national crisis and war. Following the tradition established by Hamilton in the rapid redemption of the Revolutionary War debt, the decades following the Civil War and the First World War, a large part of national expenditures were devoted to servicing the debt. From 1866 to 1875, the portion of ordinary expenditures including interest was spent or retiring the debt was between 40 and 60%. Zuckerman in 1925 argued that the burden the current generation

had to shoulder in repaying war debt should be spread over a longer redemption period. He advocated a system similar to that of Europe where national debts were viewed as perpetual interest bearing securities. In Europe, efforts to repay the debt following a war were soon followed by the next war that necessitated more borrowing. In their view, the ongoing level of borrowing, embodied in the national debt of European countries, became a market for new capital to be used for expansion of commerce and a source of new wealth.

Since the Great Depression, deficit spending has been used as a means to stimulate economic activity. John H. Williams (1941) traced the use of deficit government spending for economic recovery to a visit to the United States by John Maynard Keynes in June 1935. Keynes presented to the economist of the Roosevelt Administration a precise formula that certain levels of government spending each month would lead the nation to full recovery. Exactly when Roosevelt adopted deficits as the formal policy of fighting the depression is not clear. In campaign speeches he was still touting the virtues of a balanced budget, however, as the deficits grew, it became a generally held conviction that the deficits were key to the recovery. Congress passed funding for new programs and even greater deficits in 1937. Fundamentally, Keynes proposed that instead of waiting for private investment to return, the government must replace the investment with deficit spending.

United States Senator Paul H. Douglas of Illinois summed up the challenges of the post World War II economy in reviewing the chances of a balanced budget in 1950. Senator Douglas, a war hero and University of Chicago Economist, noted the shift in military spending from the war economy to one based on the realities of the Cold War. The need to support our allies and rebuild Europe was necessary to prevent the spread of communism. Servicing the war debt, the cost of occupying Japan and Germany, the liberal veteran’s benefits and expenditures on atomic

weapon development rounded out the budget items related to the past war and the continued aggression of the Soviet Union. In his article in the Journal of Finance, Senator Douglas put the level of war spending during World War II and level in 1950 at 77% of total government expenditures. These were more the realities of a "warfare world rather than in a welfare state". The budget in 1950 provides the first glimpse of the factors that would drive government spending in the decades to come. Senator Douglas's final remarks on achieving a balanced budget for the United States as a new world superpower emphasized that fiscal policy discipline is more a moral issue than economic. These sentiments are as true today as they were in 1950. The challenge of democratic government, according to Douglas, requires a higher degree of morality and depends on "the fundamental good sense and civic decency of the American people."

During the prosperity of the 1950's, President Eisenhower, after ending the Korean War in 1953, was able to balance the budget in 1956. Considered forward looking for the time, he was able to achieve some sweeping liberal objectives aimed at improving the welfare of broad sectors of the public. In his second term, expansion of existing domestic programs and new enactments made it increasingly hard to achieve a balanced budget. The continued escalation of Cold War tensions convinced Eisenhower that the federal government could not fund both a progressive domestic agenda and national defense programs. Eisenhower also viewed a balanced budget and a sound fiscal footing as essential to leading the Free World in opposition to communism. Toward the end of his second administration, Eisenhower became the fiscal conservative that we know today (Sloan 1989).

The recession of 1958 to 1959 derailed the net budget surplus of 1956 to 1958. This worldwide recession was the worst since the Great Depression. The severity of the recession was

attributed to the Republican's stubborn adherence to conservative fiscal policies and a commitment to a balanced budget. Gable (1959) explains that fundamental economic and social philosophy and long-run fiscal concerns were the primary considerations by the Eisenhower administration. They were convinced that the business cycle involved certain inevitable and unfortunate social costs such as unemployment. It was a generally held belief that market forces would self correct and were more effective than government intervention. Gable draws a picture of a weak and unresponsive administration, unwilling to apply the appropriate and deliberate measures of government deficit spending. Fiscal policy tools that were known by staff economist to be effective during the Great Depression and proven to work in fighting down turns were trumped by stubborn adherence to conservative ideology. In keeping with this fundamental philosophy and to reduce inflationary fears, the Federal Reserve tightened credit when lower interest rates would have had a simulative effect on the economy (FRASER 2011). Auto sales fell by 31% from 1957 to 1958. This was the lowest level since the end of World War II. The failure of the Eisenhower Administration to act quickly to curb the severity of the recession of 1958, paved the way for the American dream of a better world with the promise of real and lasting progress in equality and social justice. The American electorate chose John Kennedy in November 1960 to lead the nation.

The history of the national debt of the federal government and the use of deficit spending to pay for national crises reveal fundamental political philosophies that have been debated since the founding of our nation. Individuals know intuitively the merits of living within one's means and to use debt financing responsibly. It is often necessary to borrow money to provide a safe and comfortable home for our family and purchase a car so we can carry on essential economic activities. We obtain education loans to help ensure the future success of the next generation.

Economist understand the benefits of budget deficits to stimulate the economy. Political leaders understand too well the effect on the electorate of shifting the burden of the national debt to the next generation and the popularity of reduced taxes. The welfare of future generations is often invoked as reasons to act decisively to balance the budget. Not surprisingly, there are few proponents that specifically advocate the raising of taxes to balance the budget and build surpluses so that the future generations will be free to enjoy the fruits of our struggle in a lower tax environment. Likewise, there are no true representatives of subsequent generations to protest the future imposition of burdens of a growing national debt and threaten elected representatives with defeat at the polls. The questions to be examined with the remainder of the paper are as follows: What have been the trends of the growth of federal expenditures, revenues, and the associated budget deficits and surpluses from the Kennedy Administration to the present? From an economic standpoint, what are the principal arguments for and against deficit spending? Do our elected representatives and we have the ability to balance the budget and the long-term sustained commitment to reduce the national debt? If we truly care about the welfare of future generations, why have not we balanced the budget already?

Trends in Spending, Revenue and Deficits

The Federal Budget deficits and surpluses are shown in Figure-1 below. For the 50 years from 1960 to 2010, the federal budget has been balanced or had a surplus for only six years. The most recent and largest surpluses were during the late 1990's during the Clinton administration. The largest budget deficits were in the years 2009 and 2010. Generally, the largest deficits are associated with periods of economic recession when corporate and individual income tax revenue falls and spending cannot be adjusted down for existing programs. Often government spending will increase due to income protection programs and efforts to stimulate or rescue some

sector of the economy. Tax cuts, further adding to the deficit, are also enacted to stimulate the economy by encouraging consumer spending.

There are other trade-offs where reductions in one area result in additional expenditures in another. Mark Drabenstott (2005), Assistant Director of the Federal Reserve Bank, describes an excellent example of the trade-offs in the expenditures for community development. In 1978, President Carter issued an executive order establishing the Economic Adjustment Committee at the Department of Defense (DOD) to work to minimize the effect on communities of base closures. The spike in the community development expenditures in 1978 shown in Figure-2 is associated with the drop in defense expenditures in Figure-3. This example further illustrates the fragmented nature of the budgeting authority in the "Community and Regional Development" category in the Federal Budget. DOD expenditures are aggregated with the costs of the economic development activities of other agencies. For example, the Department of Agriculture is responsible for rural development. The Department of Health and Human Services implements programs supporting low-income Americans. Housing and Urban Development has programs in their area of responsibility as does the Interior Department aimed at Native Americans. Congress involves most agencies in Community and Regional Development in some form or another through various enactments with little evidence of coordination of effort. Disaster assistance is also included in the Community and Regional Development Budget. This explains the peak in 2006 in Figure-2 with the massive relief effort following Hurricane Katrina.

A closer examination of the trend in defense spending has shown a steady downward trend from nearly 50% of the total budget in the 1960's and 20% of GDP to around 20% of the total budget and 5% of GDP from 2003 forward. The early 1960's saw the height of the Cold War with the Berlin Crisis, The Bay of Pigs, and the Cuban Missile Crisis and the associated

arms race. A peak at about 40% of total spending represents the troop buildup in Vietnam in 1966, 1967, and 1968. The percent of total budget fell steadily until the Reagan years and the resumption of the arms race with the Soviet Union. The weakened economy of the USSR could not sustain the military buildup and this lead to the fall of the Soviet Union in 1991. After the demise of the Soviet Union, military spending continued the downward trend to the lowest levels of the 50-year period from 1962 to the present in 2011. The War on Terrorism and the associated conflicts in Iraq and Afghanistan explains the current elevated levels beginning in 2002.

Figure-4 shows the trend of Social Security spending over the 50-year period of study. Since the mid 1970's outlays have been trendless between the 20 to 25% range of total budget. Expenditures as a percentage of GDP are steady during the same period. The problem underlying funding of Social Security benefits through payroll contributions lies with the changing demographics of the United States workforce. As the number of retirees increases with relatively fewer members of the workforce to maintain adequate fund levels, the trust fund is expected to have more outflows than payments into the fund within the next 20 years. Two other entitlement programs show alarming upward trends and represent major challenges to the Federal Government. Figure-5, Medicare and Figure-6, health programs including Medicaid together with Social Security comprise almost 44% of the mandatory budget outlays in 2010 and are projected to exceed 50% of the total budget in a few years.

Figure-7 below shows the total Federal Budget as a percentage of GDP with the relative percentages of mandatory versus discretionary spending. The portion of the budget that the United States Congress can influence in the short term, the discretionary portion, is decreasing while the mandatory spending, mainly entitlements such as Social Security, Medicare and other health programs, is increasing. This is the fundamental problem in reducing the yearly budget

deficit while maintaining the current level of taxes. Non-partisan opinion in the current political debate in 2011 recognizes that serious changes to reduce the mandatory entitlement programs have to be considered. The rapid growth in health care costs is the primary reason behind the growth in the programs. Difficult decisions concerning the level of program benefits have to be made by Congress. Political actors at all levels need to decide the level of tax burden required to sustain these entitlement programs.

On the revenue side, the percentages of total receipts from 1962 to present is shown in Figure-8. As indicated, individual income taxes have ranged from 40 to 50% of total revenue. Corporate income taxes have a wider range from the smallest percentage at 6.2% in 1983 to 23% in 1966, but the amount business contribute is generally becoming smaller from the highs in the 1960's. Understandably, they are smallest during recession years of 1983, 2002, and 2008. Since the mid 1970's, social insurance and retirement tax receipts have exceeded 30% of the total. Since 1984, excise and other taxes have been below 10% of the total. The "Other Taxes" category includes estate and gift taxes, customs duties, and fees.

Not reflected in the graphs, but contained in the data retrieved from the Presidents Budget web site, are some interesting facts about excise tax revenues. Two significant excise taxes are on alcohol and tobacco. Tobacco tax receipts more than doubled from $7.6 billion in 2008 to $17.1 billion in 2010. From 1980 to 1986, the federal government collected from oil companies $78.2 billion in excise taxes on crude oil windfall profits. Some other significant excise taxes, gasoline for example, are paid into the transportation trust fund. Other trust accounts are funded by excise taxes from Airport and Airways activities. Inland waterways and funds to compensate victims of vaccine injury and black lung disease are other trust accounts. The taxes on indoor tanning services will come on line in 2011. Excise Taxes are often applied to change the

behavior of the public. In 1989, California increased the tax on a pack of cigarettes by 25 cents. Estimates in the associated reduction of cigarette consumption were close to 6% the same year (Flewelling 1992). In a longer term study, covering the period from 1955 to 1988, statistics show that for every 1% increase in price from taxes, there is a corresponding 0.47% fall in cigarette consumption (Peterson 1992).

Table-1 shows the federal individual income tax rates for those individuals that are married and file joint returns at 10-year intervals from 1962 to 2011. The schedules clearly show efforts to simplify the tax system and to reduce overall taxes on individuals. In 1962, there were 25 tax brackets. In 1992, there were three. Currently, in 2011 there are six. In 1962, the lowest marginal tax rate was 20% with the highest rate topping out at 91% for those making more than $400,000. For 2011, the lowest rate is 10% and for individuals reporting income over $379,150, the top rate is 35%. The impact of the Bush era tax cuts can be analyzed by comparing the tax rates in 2002 with 2011. The top income for the 15% bracket was expanded from $46,700 to $69,000 to benefit the middle class. The highest tax bracket was reduced from 38.6% to 35%. The tax reductions were passed in 2001 and were phased in over the 10 years that the law was in effect with rate decreases coupled with expansion of the income amount ceilings in the lower tax brackets. To understand the impact of the change with an example, for an individual with an unadjusted income of $250,000, the tax liability would be $9,358 less in 2011 than in 2002. For an individual with an unadjusted income of $400,000, their tax savings would be $15,289.

Federal corporate income tax rates are shown in Table-2. The taxes on business income have generally shown a downward trend from 1962 forward, but the tax brackets have expanded from just two brackets in 1962 to eight in 2008. To illustrate the reductions with an example, in 1962 with a top tax bracket of 52%, the corporate tax of a company showing a net profit of $10

million would be approximately $5.2 million. A company would pay $3.4 million on the $10 million in 2008, a savings of $1.8 million.

Political and Economic Considerations in the Budget Debate

Balancing the federal budget has been a rallying cry in political campaigns ever since deficit spending became the norm in financing the federal government. The recent arguments blaming the conservative's unreasonable tax cuts and the social welfare driven runaway spending of liberals are not new. Dan Wood (2000) believes that despite persistent deficits, most in politics believe in the principal of a balanced budget and that a balanced budget is the "normative preference" of politicians on both sides of the aisle. Wood found that there is a "law-like equilibrating force" that moves a deficit toward balance. The force was stronger the larger the deficit because of the associated increased public awareness of the economic implications of a large negative budget balance.

The more cynical believe that we have developed a political system that is incapable of producing a balanced budget. The "fiscal illusion" hypothesis holds that politicians tend to underestimate the current and future costs of public programs (Schultze 1992). Politicians are too busy providing short-term rewards to their constituents and are only concerned on how to be reelected. Increased taxes are a sure bet to garner negative result at the polls. This makes efforts to balance the budget by increasing revenues very difficult. Because of the expectations of the public concerning entitlement programs, long-term problems in funding Social Security and Medicare are not approached and smaller, focused programs are cut instead. The current debate has the Republicans promoting spending cuts to reduce the deficit. The Democrats are willing to increase revenues by increasing taxes as long as the tax burden doesn't fall on their voters. Tax cuts are often proposed by both sides during economic downturns to stimulate the economy.

Macroeconomist are divided on how much government spending stimulates the economy. Keynesian macroeconomists believe that government spending has a multiplier effect and that 1% of federal outlays results in a much greater growth in GDP (Grauwe 2009). This in turn results in more tax revenue and enables reduction in the deficit or more spending to further growth. The arguments against deficit spending holds that it can lead to inflation, high interest rates and takes money from the system that would normally be available for private investment. It is a commonly held belief among economists that the volatility in budgets and deficits is caused by the performance of the economy (Haider 1980). A drop in real growth raises government expenditures and reduces tax revenue. An increase in the unemployment rate also reduces government receipts, increases government payments in income support, and raises the deficit by the amount of the decrease and payments.

Conclusion

Regardless of the seemingly insurmountable political obstacles, the urgency of the potential negative economic consequences of continued large deficits dictates that drastic changes must occur. The non-partisan consensus agrees that something must be done to halt the rise in deficit spending. In order to reduce the deficit, the first task must focus on fixing Medicare and Social Security. If costs for mandatory entitlements are not reduced, all other efforts combined will not work to solve this fundamental problem. For Medicare and the New Health Care program, the fix needs to involve expanding programs that encourages intelligent choices as s good consumers of health care and promotes good health through prevention. The rise in health care cost must be slowed. The Bush tax cuts have to be eliminated for all brackets. The middle class has to share the increased burden with the more affluent. In order to maintain the competitive edge of American companies internationally, corporate income taxes should not

need to be raised. The largest discretionary budget item, Defense spending, needs to be reduced by eliminating unnecessary weapon systems and reducing our presence overseas. The Social Security fix has to involve raising the retirement age to 70.

Fundamentally, the social safety net needs to be maintained. In spite of the argument that aid to the poor does not eliminate poverty, programs such as food stamps, Medicaid, housing assistance, income credit to the working poor, and other assistance programs have been successful. Success has to be measured by the fact that the elderly, adults and children receive basic medical care, nutrition and housing assistance. Often federal programs are a matter of life or death for the poor. Programs left to the states alone to administer suffer due to the fundamental dilemma of the different tax base in communities. Areas that don't have the tax base are usually the ones with the most citizens in need of assistance. Affluent areas have the means to provide services, but hesitate to do so due to the fear of attracting the poor to their area. This fundamental problem in our society is the reason that the federal government must take the lead in providing the safety net (Caraley 1996).

There are no easy answers and no easy solutions. The current shift of the political climate to the right politically may be beneficial to increase the sense of urgency of the deficit and debt crisis. However, narrowly focused and drastic measures to reduce the tax burden and the size of government stalls when the American people realize that the true objective of the tax reforms of the ultra Conservatives is to bleed the federal government dry so social programs cannot be funded. These efforts fail due to the fundamental decency of the American people and their sense of fairness. The opponents of the social safety net work very hard but the have not been able to undo the progress that we have made as a nation in terms of social equity.

Figures and Tables

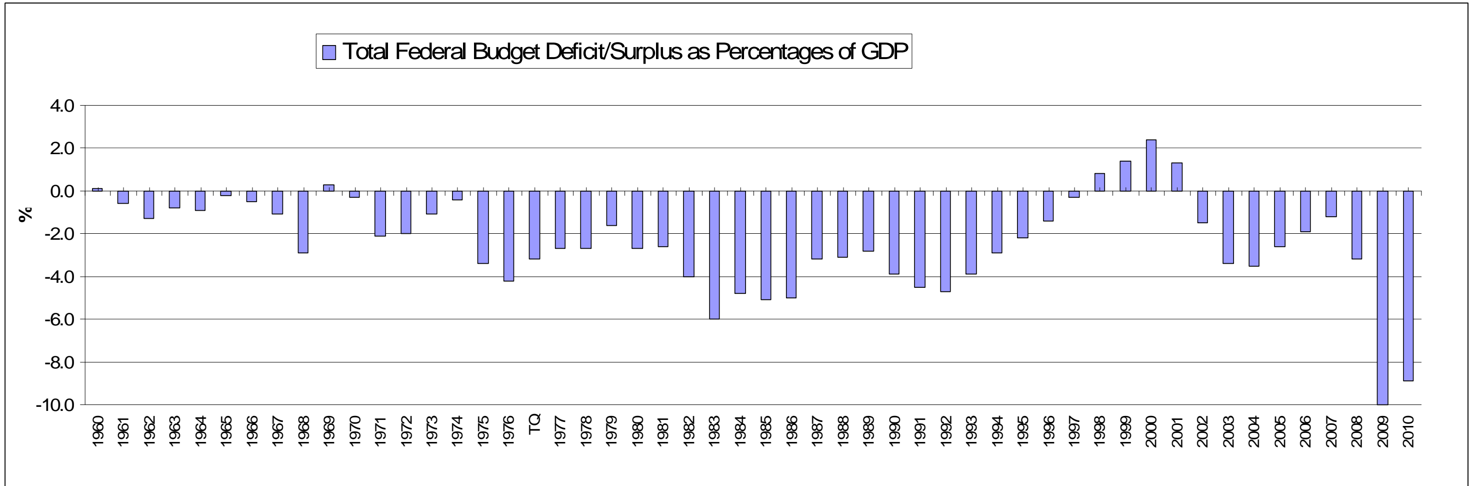
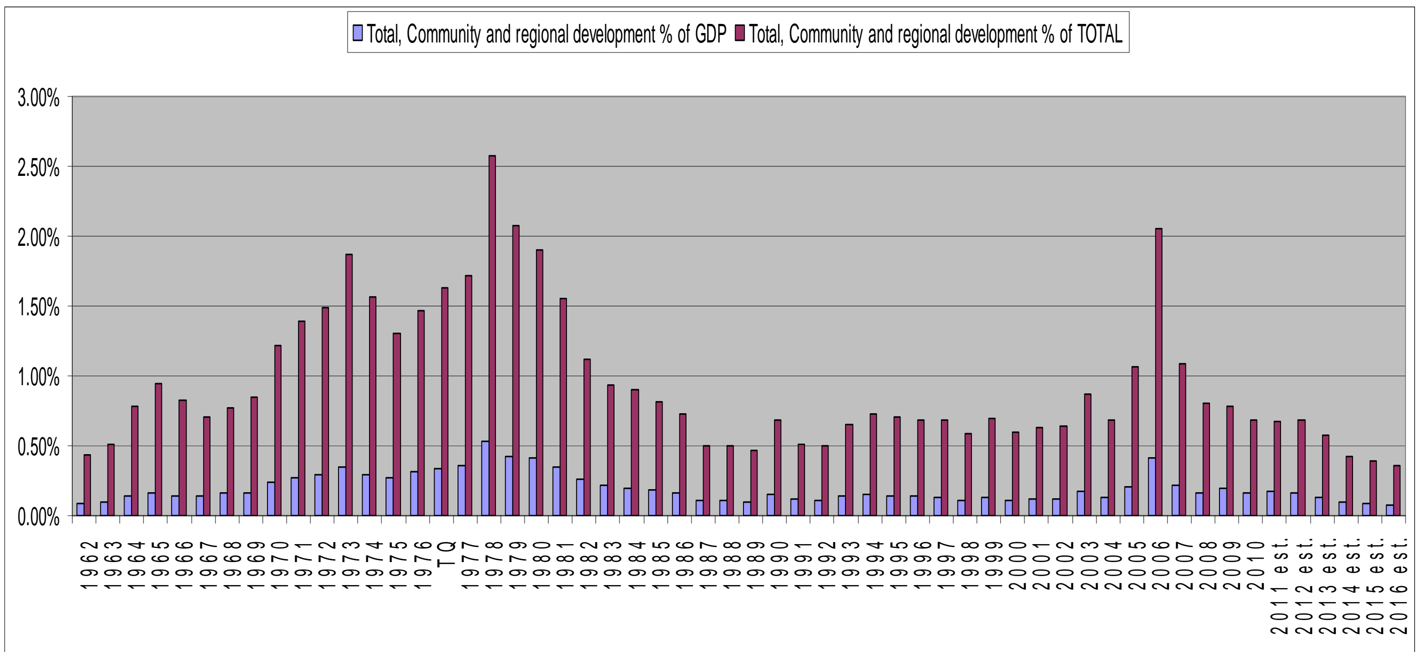


Figure 1 (from: http://www.whitehouse.gov/omb/budget/Historicals)



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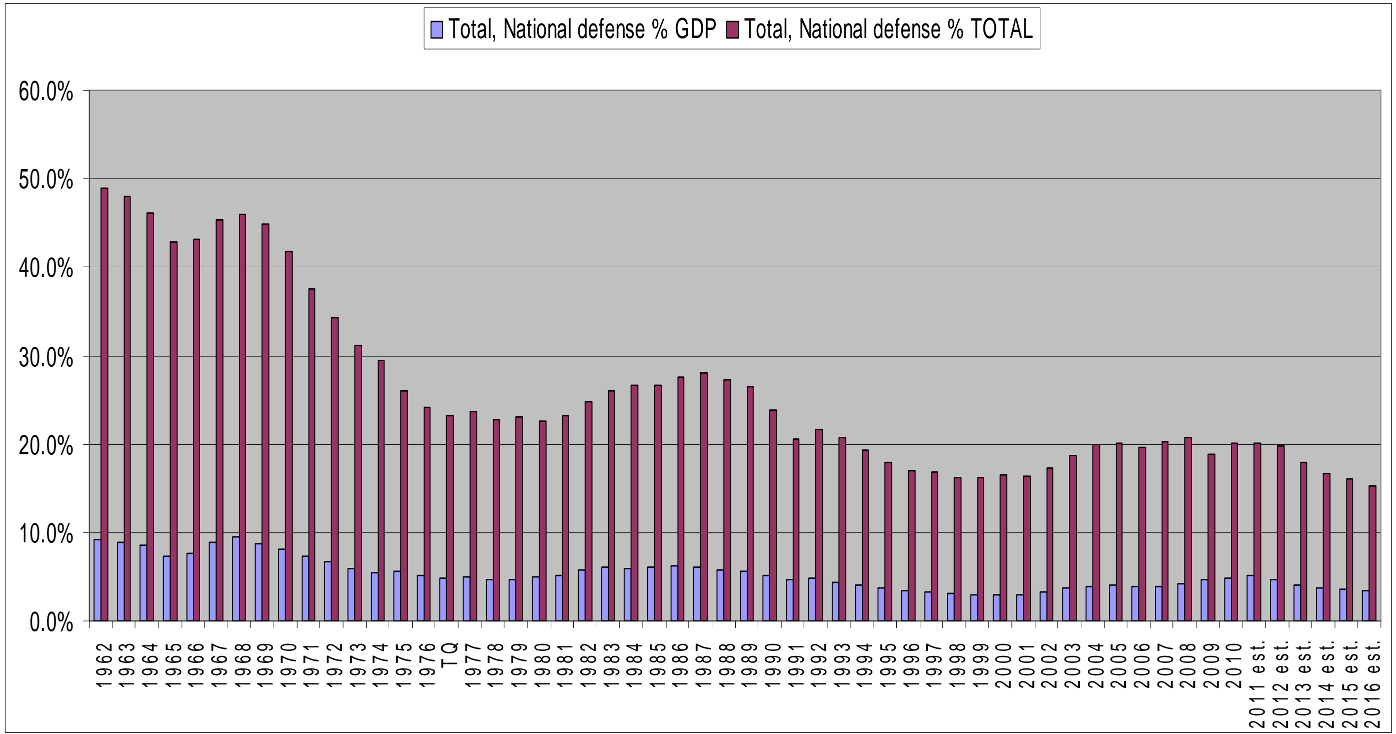

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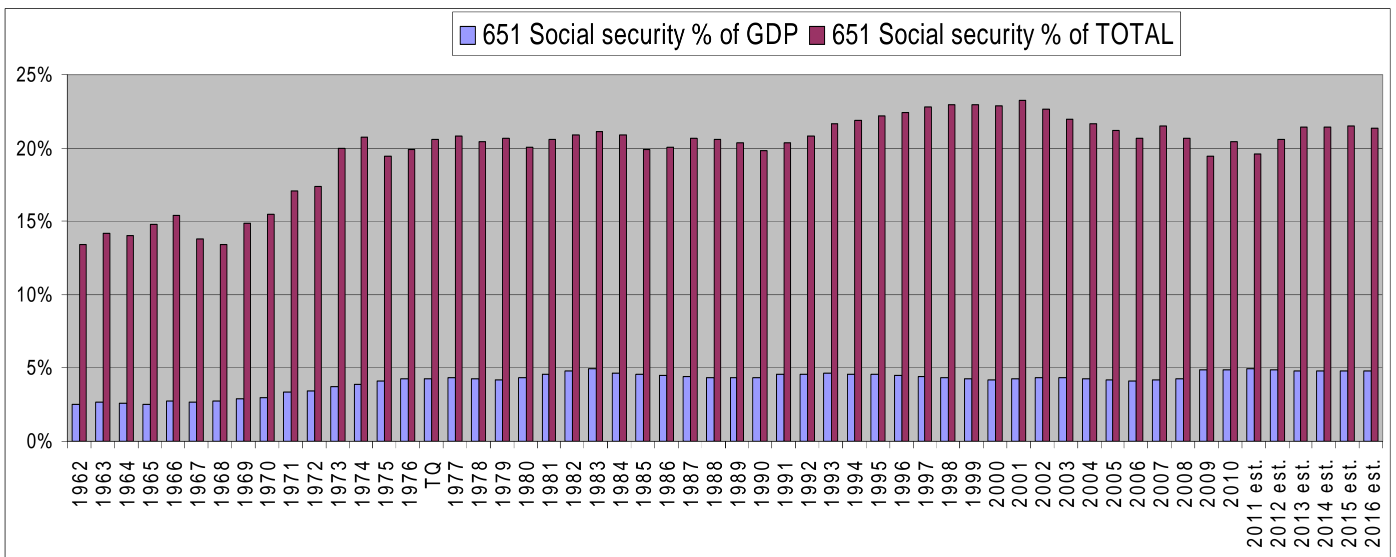

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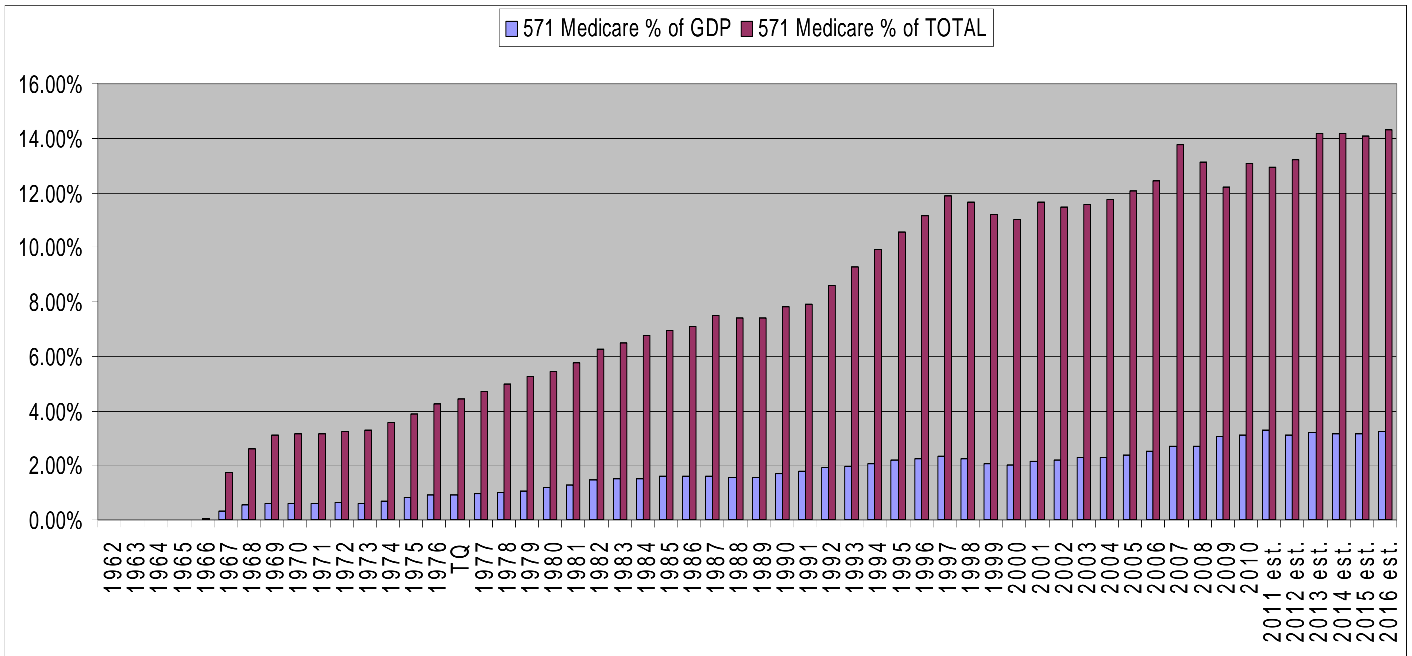

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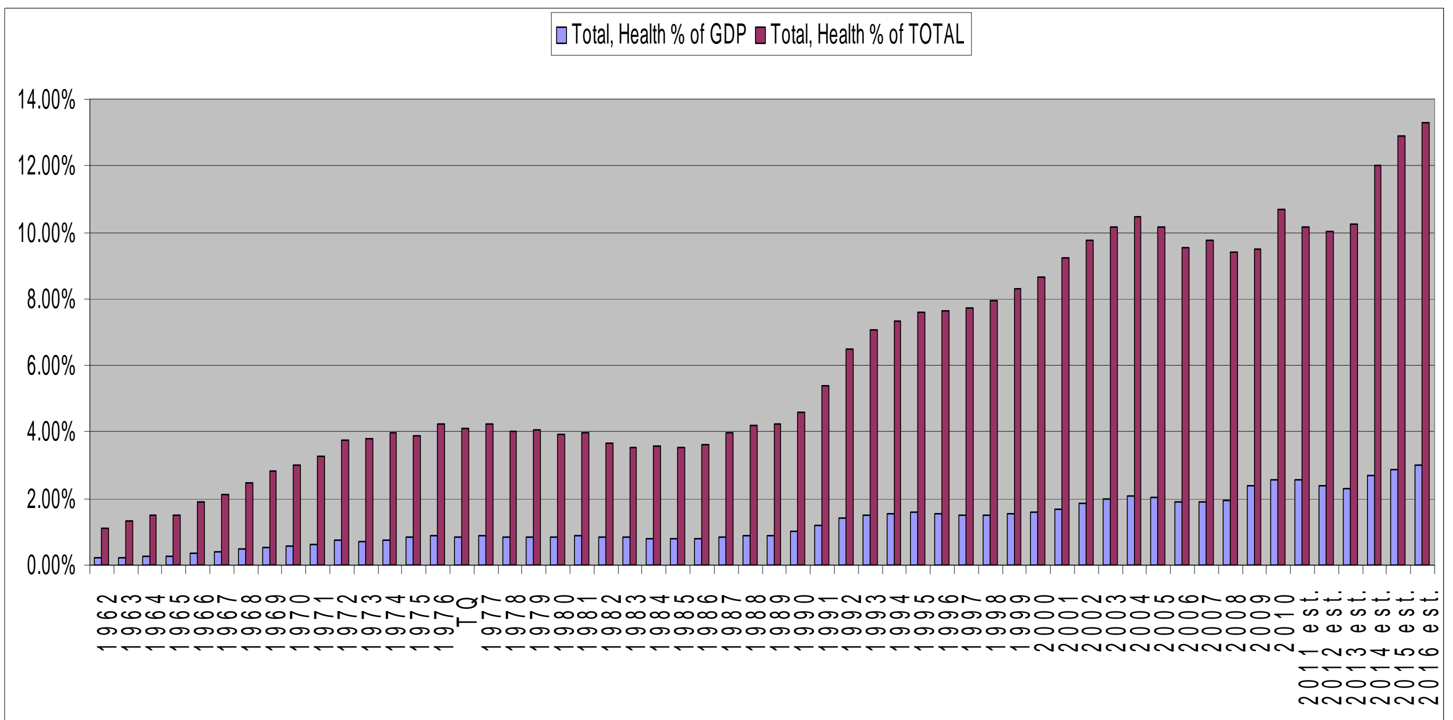

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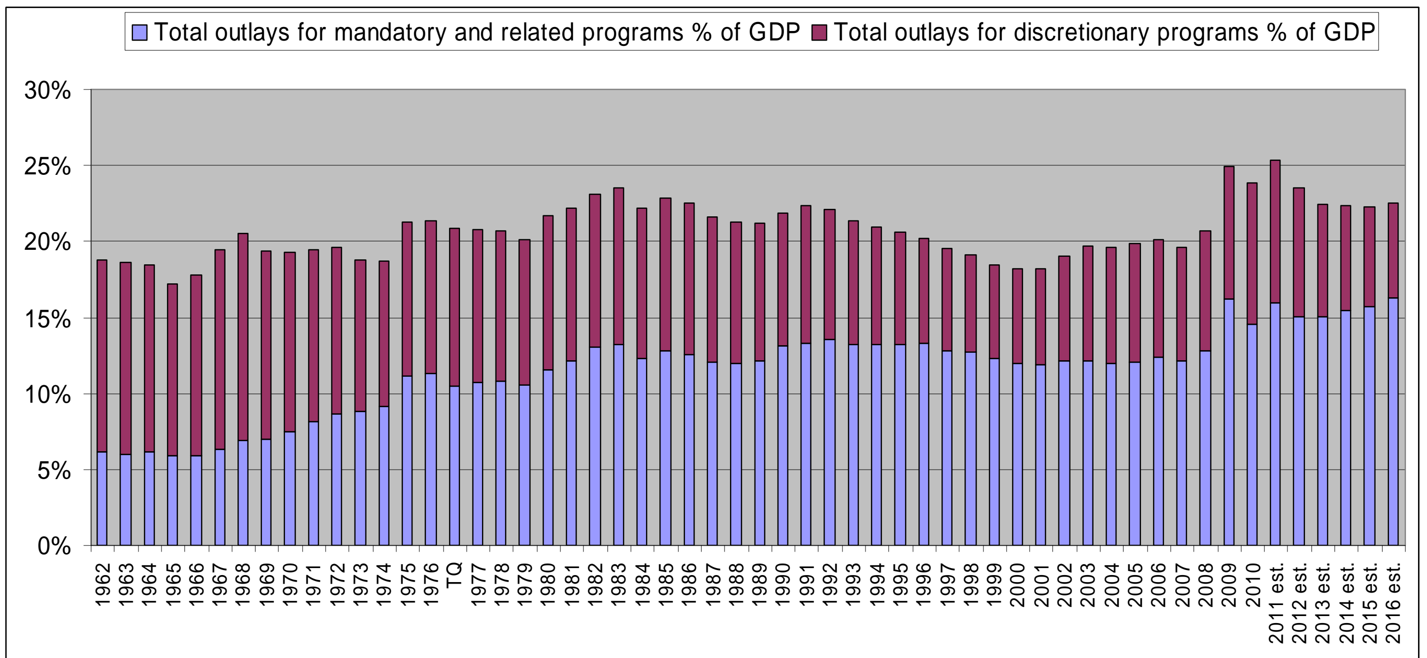

Figure 7 (from: http://www.whitehouse.gov/omb/budget/Historicals)

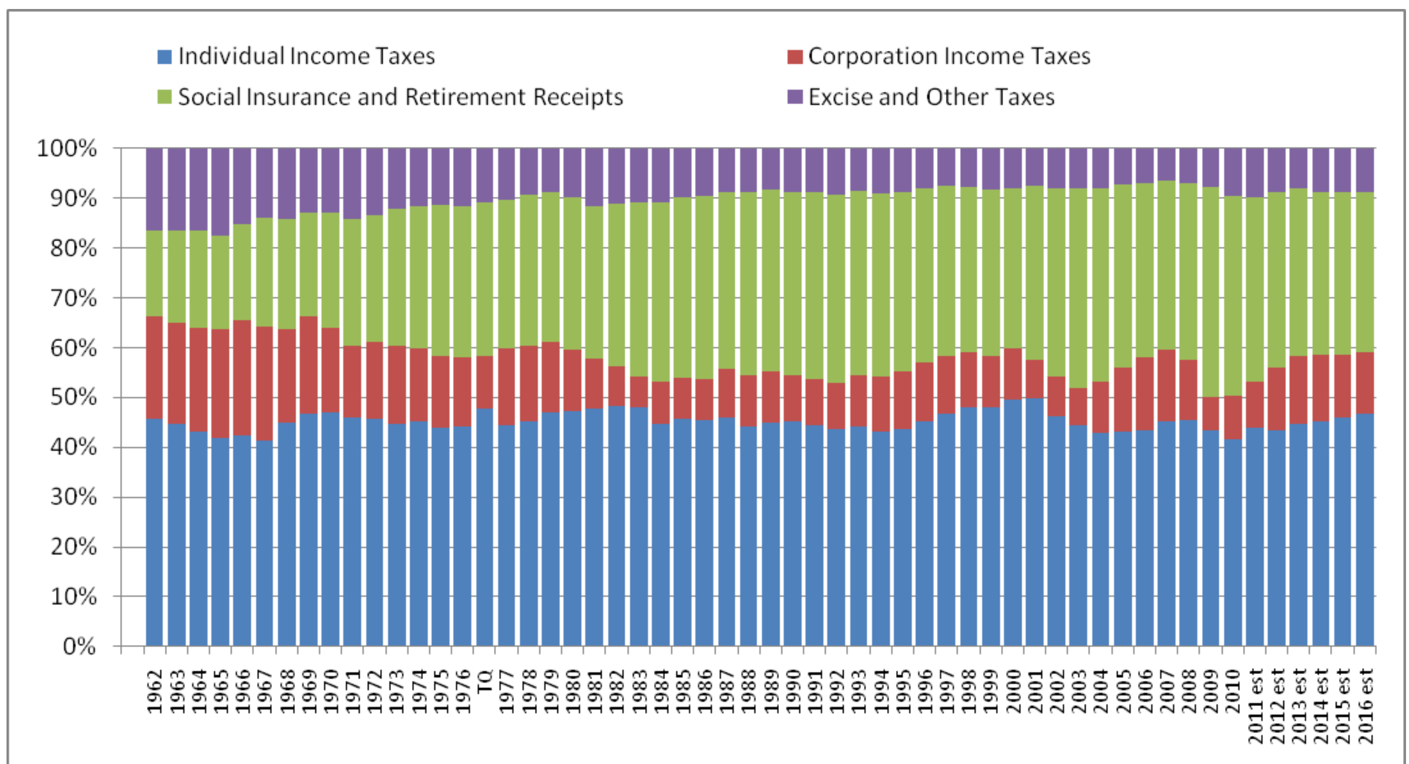

Figure 8 (from: http://www.whitehouse.gov/omb/budget/Historicals)

Federal Individual Income Tax Rates History

Selected years 1962-2011

1962

Married Filing Jointly

Marginal Tax Rate	Tax Brackets Over	But Not Over
20.0%	$0	$4,000
22.0%	$4,000	$8,000
26.0%	$8,000	$12,000
30.0%	$12,000	$16,000
34.0%	$16,000	$20,000
38.0%	$20,000	$24,000
43.0%	$24,000	$28,000
47.0%	$28,000	$32,000
50.0%	$32,000	$36,000
53.0%	$36,000	$40,000
56.0%	$40,000	$44,000
59.0%	$44,000	$52,000
62.0%	$52,000	$64,000
65.0%	$64,000	$76,000
69.0%	$76,000	$88,000
72.0%	$88,000	$100,000
75.0%	$100,000	$120,000
78.0%	$120,000	$140,000
81.0%	$140,000	$160,000
84.0%	$160,000	$180,000
87.0%	$180,000	$200,000
89.0%	$200,000	$300,000
90.0%	$300,000	$400,000
91.0%	$400,000	-

1972

Married Filing Jointly

Marginal Tax Rate	Tax Brackets Over	But Not Over
14.0%	$0	$1,000
15.0%	$1,000	$2,000
16.0%	$2,000	$3,000
17.0%	$3,000	$4,000
19.0%	$4,000	$8,000
22.0%	$8,000	$12,000
25.0%	$12,000	$16,000
28.0%	$16,000	$20,000
32.0%	$20,000	$24,000
36.0%	$24,000	$28,000
39.0%	$28,000	$32,000
42.0%	$32,000	$36,000
45.0%	$36,000	$40,000
48.0%	$40,000	$44,000
50.0%	$44,000	$52,000
53.0%	$52,000	$64,000
55.0%	$64,000	$76,000
58.0%	$76,000	$88,000
60.0%	$88,000	$100,000
62.0%	$100,000	$120,000
64.0%	$120,000	$140,000
66.0%	$140,000	$160,000
68.0%	$160,000	$180,000
69.0%	$180,000	$200,000
70.0%	$200,000	-

1982

Married Filing Jointly

Marginal Tax Rate	Tax Brackets Over	But Not Over
0.0%	$0	$3,400
12.0%	$3,400	$5,500
14.0%	$5,500	$7,600
16.0%	$7,600	$11,900
19.0%	$11,900	$16,000
22.0%	$16,000	$20,200
25.0%	$20,200	$24,600
29.0%	$24,600	$29,900
33.0%	$29,900	$35,200
39.0%	$35,200	$45,800
44.0%	$45,800	$60,000
49.0%	$60,000	$85,600
50.0%	$85,600	-

1992

Married Filing Jointly

Marginal Tax Rate	Tax Brackets Over	But Not Over
15.0%	$0	$35,800
28.0%	$35,800	$86,500
31.0%	$86,500	-

2002

Married Filing Jointly

Marginal Tax Rate	Tax Brackets Over	But Not Over
10.0%	$0	$12,000
15.0%	$12,000	$46,700
27.0%	$46,700	$112,850
30.0%	$112,850	$171,950
35.0%	$171,950	$307,050
38.6%	$307,050	-

2011

Married Filing Jointly

Marginal Tax Rate	Tax Brackets Over	But Not Over
10.0%	$0	$17,000
15.0%	$17,000	$69,000
25.0%	$69,000	$139,350
28.0%	$139,350	$212,300
33.0%	$212,300	$379,150
35.0%	$379,150	-

From Tax Foundation: www.taxfoundation.org

Table 1

(from: www.taxfoundation.org)

Federal Corporate Income Tax Rates
Income Years 1953-2008

Year	Bracket	Percentages
1953-1963	First $25,000 (Normal Rate)	30
	Over $25,000 (Add Surtax of 22%)	52
1964	First $25,000 (Normal Rate)	22
	Over $25,000 (Add Surtax of 28%)	50
1965-1967	First $25,000 (Normal Rate)	22
	Over $25,000 (Add Surtax of 26%)	48
1968-1969	First $25,000 (Normal Rate)	22
	Over $25,000 (Add Surtax of 26%)	48
	With 10% Surcharge	
	First $25,000 (Normal Rate)	24.20
	Over $25,000 (Add Surtax of 26%)	52.80
1970	First $25,000 (Normal Rate)	22
	Over $25,000 (Add Surtax of 26%)	48
	With 2.5% Surcharge (c)	
	First $25,000 (Normal Rate)	22.55
	Over $25,000 (Add Surtax of 26%)	49.20
1971-1974	First $25,000 (Normal Rate)	22
	Over $25,000 (Add Surtax of 26%)	48
1975-1978	First $25,000 (Graduated Normal Rate)	20
	Next $25,0000 (Graduated Normal Rate)	22
	Over $50,000 (Add Surtax of 26%)	48
1979-1981	First $25,000	17
	$25,000 to $50,000	20
	$50,000 to $75,000	30
	$75,000 to $100,000	40
	Over $100,000	46
1982	First $25,000	16
	$25,000 to $50,000	19
	$50,000 to $75,000	30
	$75,000 to $100,000	40
	Over $100,000	46
1983-1984	First $25,000	15
	$25,000 to $50,000	18
	$50,000 to $75,000	30
	$75,000 to $100,000	40
	Over $100,000	46
1985-1986	First $25,000	15
	$25,000 to $50,000	18
	$50,000 to $75,000	30
	$75,000 to $100,000	40
	$100,000 to $1,000,000	46
	$1,000,000 to $1,405,000	51
	Over $1,405,000	46
1987-1993	First $50,000	15
	$50,000 to $75,000	25
	$75,000 to $100,000	34
	$100,000 to $335,000	39
	Over $335,000	34
1994-2008	First $50,000	15
	$50,000 to $75,000	25
	$75,000 to $100,000	34
	$100,000 to $335,000 (g)	39
	$335,000 to $10,000,000	34
	$10,000,000 to $15,000,000	35
	$15,000,000 to $18,333,333	38
	Over $18,333,333	35

Table 2 (from: www.taxfoundation.org)

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