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The Skyrocketing Federal Budget Deficit:

Worrisome or Not?

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Introduction

In **fiscal year** 2007, the United States government ran a **budget deficit** of $161 billion; literally, this means the government spent $161 billion more than the revenues (mainly taxes) it took in. In 2009, the deficit totaled $1.4 trillion, and projections by the **Congressional Budget Office** (CBO) suggest the deficit will remain large by historical standards for years to come. These are big numbers that few of us can really grasp. Imagine this—a trillion one-dollar bills laid end to end exceed the distance from the earth to the sun.

In trying to understand budget deficits, as with many issues in economics and politics, things can get complicated fast if we don't first develop some basic building blocks and then use the resulting fundamentals to address key questions, including:

- How and why have budget deficits grown so fast?
- What role have economics and politics played?
- What is worrisome about the exploding deficits?
- What can be done to reverse the recent trend toward larger deficits?

A Primer on the Budget Deficit

Let's focus first on some fundamentals. If a family's income is greater than what it spends, it is running a surplus and the excess of unspent income, called savings, will typically be used to acquire financial assets, such as stocks, bonds, and interest-bearing deposits at financial institutions. Alternatively, if a family's spending exceeds its current income, it is running a deficit and must borrow to finance the difference (or cash-in some of the financial assets it acquired in earlier years when it was running a surplus).

Similarly, if the federal government takes in more money than it spends, it runs a surplus; conversely, if the government spends more than it takes in, it runs a deficit and must borrow to cover the gap.

Fiscal Year: As is the case for many corporations, the federal government does not use the calendar year (January-December) to keep its financial books. Rather, it uses a fiscal year that runs from October through the following September.

Budget Deficit: Total government spending minus total government revenues; since all spending must be paid for, equals the amount the government must borrow in financial markets to finance the difference.

Congressional Budget Office: The U.S. Congress established the CBO in 1974. Its mandate is to provide Congress with: (1) objective, nonpartisan, and timely analyses to aid in economic and budgetary decisions on the wide array of programs covered by the federal budget; and (2) the information and estimates required for the Congressional budget process. See http://www.cbo.gov/ for a wide array of valuable information on the Federal budget.

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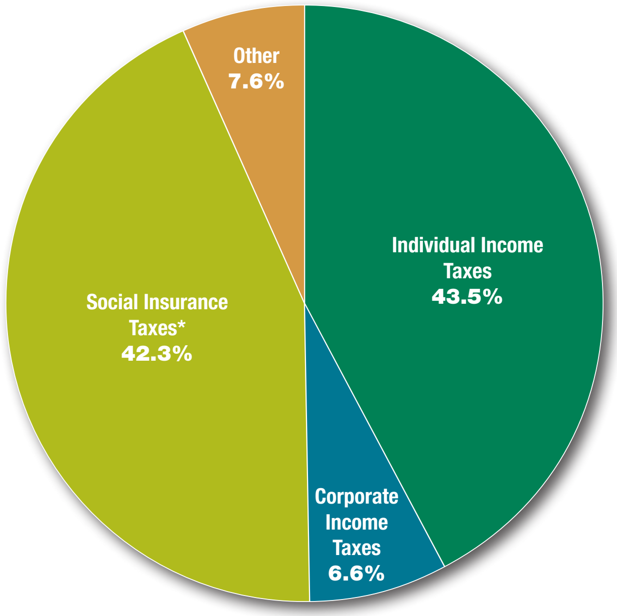
CHART 1

Composition of Federal Government Revenues, Fiscal Year 2009
(Percentage of Total)



*Mainly Social Security and Medicare Taxes

Source: Congressional Budget Office

Government revenues consist mainly of taxes the government collects. Most of the government's revenues come from income taxes paid by individuals and **Social Security** and **Medicare** insurance payments (classified as social insurance and retirement receipts). A smaller proportion of revenues is generated through the corporate income tax. The remaining 7.6 percent of revenue is raised through other sources.

Assuming there are no changes in tax laws, what do you think explains major short-term fluctuations in government revenues? I hope you said the economy and, more specifically, the income being earned by individuals and corporations. For example, during the serious recession that began in December 2007, with spending and sales declining and unemployment rising, corporate profits and individual incomes fell dramatically. As a result, total federal government revenues plummeted, falling from $2.5 trillion in fiscal year 2008 to $2.1 trillion in fiscal year 2009, the largest annual percentage decline in more than 70 years!

Social Security: A social insurance program administered by the United States government providing retirement, disability, survivorship, and death benefits to eligible individuals.

Medicare: A social insurance program administered by the United States government providing health benefits to people who are aged 65 and over (and certain other individuals who qualify).

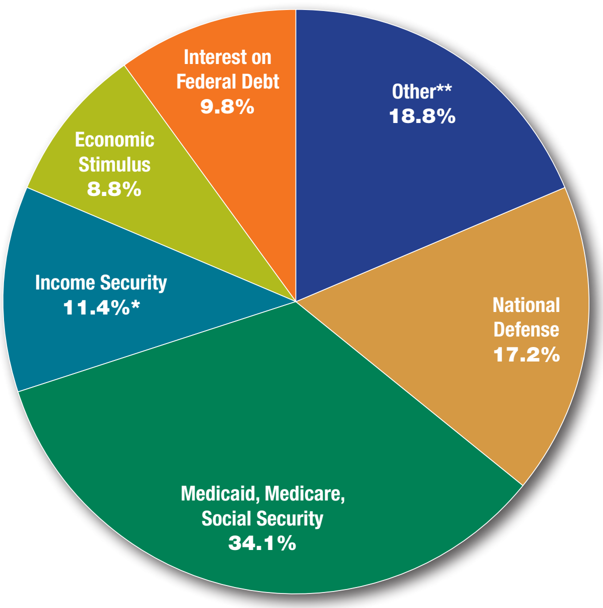
Government outlays capture spending by the government on a wide range of items and activities, including military equipment, government employees, the criminal justice system, the nation's regulatory agencies, and Social Security.

From Chart 2, you can see that more than one-third of outlays are for Medicare, **Medicaid**, and Social Security, with another 38 percent accounted for by national defense (17.2 %), income security programs, including unemployment compensation (11.4 %), and interest paid on the **federal debt** (9.8 %).

Chart 2

Composition of Federal Government Outlays, Fiscal Year 2009

(Percentage of Total)



* Includes Federal employee retirement benefits, food stamps, aid to needy families, unemployment compensation, etc.

** Rest of government, including Departments of Energy, Education, Justice, Veterans Affairs, Agriculture, and Environmental Protection.

Source: Congressional Budget Office, Office of Management and Budget.

What is the take away from this chart? More than 70 percent of federal government spending is essentially nondiscretionary in the sense that current law, political considerations, and the need to attend to national security more or less require most of such spending. However, as a casual look at the footnote on "Other" spending will suggest to you, in actuality, the proportion of spending that is nondiscretionary is

Government Outlays: The sum of government expenditures on goods and services and so-called transfer payments; that is, funds transferred to individuals (such as, Social Security and Medicare).

Medicaid: A joint federal/state, needs-based social welfare program that provides health and medical benefits to eligible individuals with low incomes.

Federal Debt: The sum of past government budget deficits minus past surpluses. The United States Treasury must keep refinancing this volume of debt plus financing the current deficit.

Nondiscretionary Spending

Interest on Federal Debt	9.8%
Income Security	11.4%
Medicaid, Medicare, Social Security	34.1%
National Defense	17.2%
Total	**72.5%**

probably much higher. For example, can you imagine a legislator from a state in the heart of America's farm belt supporting the elimination of the Department of Agriculture?

A final point to note about the pie chart on federal government outlays is that Economic Stimulus spending associated with the new programs put in place in 2009 to shore up various financial institutions in danger of failing and also to jumpstart the economy amounted to $350 billion, nearly 9 percent of total outlays. Such outlays, along with increases in payments to the growing number of unemployed and the decline in federal government revenues, pushed the overall budget deficit to a record level in 2009.

Political Forces Producing Budget Deficits

As the elected officials that build and oversee the federal budget consider its impact, keep in mind that there are two components of the budget deficit, revenues (mainly taxes) and spending. On the tax side, the forces tending to lead to deficits rather than surpluses are easy to understand—how many legislators could get elected on a platform of higher taxes? In fact, most of us would prefer lower taxes. The less we send the government, the more of our income we have to spend and save. As a result, elected officials, in general, find it very difficult to vote for higher taxes.

On the spending side, existing government programs, such as Social Security, have many supporters, especially the retired and those about-to-retire. Slicing these benefits is unlikely to be high on any elected official's list of spending reduction options. Of course, all government programs serve a constituency, and those who benefit will lobby hard to keep and even expand such programs.

Step back and think for a moment about what motivates someone to run for Congress. Usually it's a desire to improve the quality of life and standard of living for the citizens of the state he or she comes from and, hopefully, for the nation. The specifics may involve trying to design legislation that will improve the environment, health care, education in inner-city schools, the income of farmers, the stability of the financial system, the security of our national borders, the ability of

U.S. producers to compete with foreign producers in world markets, and the list goes on. The common denominator across such specific programs and initiatives is that they generally require more spending in a particular area.

But, the simple math is that more spending on Program A will increase total spending, and consequently the deficit, unless spending is cut on Program B. The problem, of course, is that if a legislator is to be successful in getting legislation passed that launches or expands Program A, she will need sufficient support from her fellow members of Congress. However, the typical "price" of such support is that she will need to agree to continue supporting many Program Bs championed by other members of Congress. Obviously, such an environment makes it very difficult to cut total spending.

You may think this all sounds a bit cynical, but the art of legislating requires the building of coalitions. Supporting each other's legislative priorities, along with party affiliation, is the glue that holds such coalitions together. The heated and partisan debate over health care legislation should not obscure the bottom line—legislators often are reluctant to raise taxes or to cut spending on specific programs because both actions are likely to cost them votes at the ballot box in the next election, as well as votes on their own favorite pieces of legislation while a sitting member of Congress.

Economic Effects of Budget Deficits

Politics aside, how do the government's actions affect the economy?

Outlays

A significant portion of spending, also referred to as government outlays, represents the direct purchase of goods and services; in fact, federal government spending on goods and services accounted for 8 percent of **Gross Domestic Product (GDP)** in the United States in 2009. Abstracting from the other components of GDP (consumption spending by households, investment spending by business firms, and spending by foreigners), an increase in government spending on goods and services increases the overall demand for goods and services in the economy and, as a result, will help generate additional sales and employment.

Gross Domestic Product (GDP): The best measure of the level of annual economic activity in an economy; equal to total spending on goods and services by domestic consumers, businesses, and governments, plus spending on domestic goods and services by foreigners (that is, exports), minus imports.

To take a recent example, a considerable portion of the massive American Recovery and Reinvestment Act (ARRA), passed by Congress and signed by the President in February 2009, provided for increased spending on road and bridge construction, cancer research, renewable energy, improved insulation of federal buildings, the expansion of wireless networks, and many other projects designed to boost the overall demand for goods and services.

Taxes

As for taxes, as mentioned earlier, the higher the taxes are for individuals and corporations, the less they have to spend, save, and invest. When the economy is in recession, reducing taxes and putting more spending power in the hands of individuals and corporations is a useful tool to encourage more spending in the private sector of the economy.

Leaving aside the ups and downs of the economy over time, from a longer-run perspective, some economists and elected officials worry that high tax rates tend to reduce the incentive for entrepreneurs to risk developing new products. In an extreme case, imagine if the government taxed away 90 percent of the profits from a new venture; surely the incentive to start a new business and bring new and improved products and services to the marketplace would be far less than if the tax rate were 20 percent. Such considerations suggest tax rates and tax policy, more generally, can affect economic growth and the overall productivity and competitiveness of an economy over time. This perspective also helps explain why many elected officials oppose significant increases in taxes as a means to reduce the budget deficit; typically, they argue for spending reductions instead.

So, to sum up, tax policy can have shorter-run cyclical effects on the economy by affecting individual and business purchasing power and spending, and longer-run effects on economic growth by affecting incentives to spend, save, and invest, and start/run businesses.

Borrowing

Finding the "right" or "best" configuration of federal government spending and taxation is part of a much larger question revolving around the proper role of government in a modern society; meanwhile, there is an unbending financial reality that faces government. If the government incurs a deficit, as it has in the United States for all but six of the last 50 years, the U.S. Treasury must go into the financial market and borrow enough to cover the excess of spending over revenues.

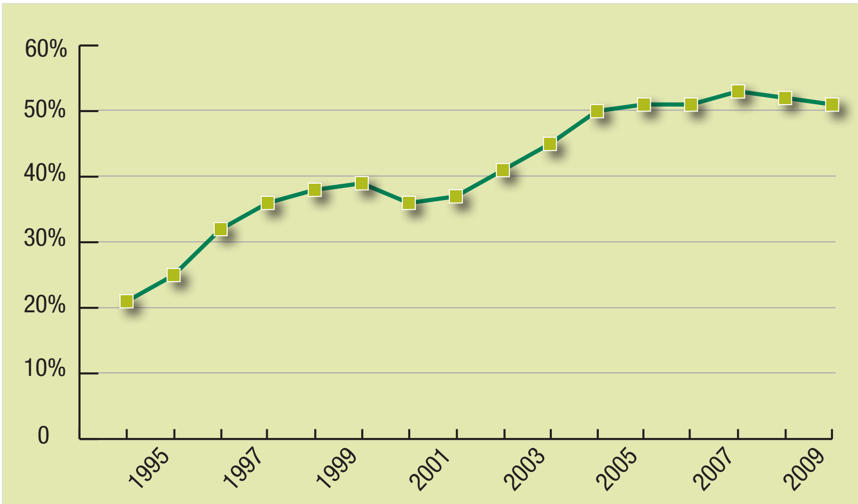
The Treasury is by far the largest single borrower in financial markets. As such, its borrowing can have a profound effect on the availability of funds for other borrowers and the cost to borrow funds (interest rates). In general, the more the government borrows, the higher interest rates are likely to be. And the higher interest rates are, the more expensive it will be for households to borrow for new homes and cars, and for businesses to borrow to expand operations. In the face of such increases, household and business spending would slow. It is in this situation that federal government spending, and the associated interest-rate increases that additional government borrowing can produce, could result in some decrease in private-sector spending. This is sometimes referred to as "crowding out"—government spending displaces some private spending.

However, please do not jump to the conclusion that whenever the government runs a deficit and borrows, interest rates will increase. There are many forces domestically and globally that affect the supply and demand for funds in the economy. U.S. government borrowing is certainly an important one, but it alone does not determine the movement of interest rates. For example, the federal government is certainly continuing to run a large budget deficit today and to borrow huge sums. But interest rates across the board, including rates on auto loans and home mortgages, remain at or near the historically low levels that emerged as the recession took hold. The main forces holding rates down have been the *massive increase in the supply of funds* provided to the financial system by the Federal Reserve and by foreign entities, particularly the Chinese, and the *weakening in the demand for funds* by households and businesses as spending on new cars, houses, and new production facilities—items usually financed at least in part by consumer and business borrowing—plummeted as the recession worsened.

The global forces affecting the supply of funds the Treasury can tap are especially important to note. Chart 3 on the next page shows the proportion of the federal debt owned by foreign entities. As you can see, more than half of the federal debt outstanding (reflecting the accumulation of annual deficits over the years) was acquired by individuals and institutions from around the world. *In fact, of the large amount of Treasury securities acquired by foreigners, China alone holds over $1 trillion, more than 25 percent of total foreign holdings*.

Chart 3

U.S. Federal Debt Held by Foreign Entities
(Percentage of Total)



Source: U.S. Treasury

The political stability of the United States and the relative safety and efficiency of our financial markets have encouraged China and others to invest in America by acquiring Treasury and other U.S. securities. However, threats to financial stability or the continuation of massive budget deficits that suggest the U.S. government is pursuing policies that could bring inflation and economic instability sometime in the future could shake the confidence of international investors, leading them to invest elsewhere. Among the many effects of such a shift reducing the supply of funds in the United States would be significant increases in interest rates.

Thus, failure to bring down the deficit significantly as the economy recovers from the recession could pose real dangers for the U.S. economy.

Is the Deficit Too Large?

A tough question to be sure. Those generally supportive of the government's policies over the past year and the resulting deficit note that: (1) a significant part of the current large deficit is the result of both the falloff in tax revenues and the increased government outlays, such as unemployment compensation and food stamps, which occurred automatically as the recession worsened; and (2) the massive discretionary increases in spending and tax reductions, particularly ARRA. Such supporters point out that the economic stimulus provided by ARRA and other Congressional and presidential policy actions were absolutely essential to avoiding a depression. Finally, they note that the deficit will shrink automatically by a considerable amount as the economy recovers, resulting in a pickup in tax revenues and a decline in recession-induced outlays.

Those observers less supportive of the government's policies point to the unprecedented size of the deficit and the likely difficulties to be faced in future years in reducing the deficit. Thus, they focus on the long-term threats to the economy that will emerge if the deficit is not dealt with. Of particular concern is the burden being placed on future generations who will have to pay the taxes necessary to cover the interest on the increasing federal debt and the possibility that foreign entities will lose confidence in the United States as a safe haven for their investments if the deficit remains large.

Here again, let's step back for a moment and think about how to judge the use of terms such as "large." Most experts believe that the current income and wealth of a nation, along with lenders' views of a country's future economic and financial health, are key indicators in judging whether a nation's deficits are "large." For this reason, analysts typically divide a nation's Federal budget deficit by GDP. The idea behind this convention is that GDP, the total value of goods produced in an economy in a given year, is a good indicator of a nation's economic health and thus its ability to continue financing its deficits.

Chart 4 on the next page shows the federal government deficit in the United States, divided by GDP, over the last 40 years. As you can see, the deficit as a proportion of GDP increased to about 10 percent in 2009, reflecting the automatic and discretionary changes in government spending and taxes discussed earlier. These data, provided by the Congressional Budget Office (CBO), also show that the deficit is projected to shrink significantly as a proportion of GDP as the economy recovers. Tax receipts will pick up with resumption in the growth of consumer and business incomes, and unemployment compensation and other recession-induced spending will decline. Both forces will lower the ratio of the deficit to GDP.

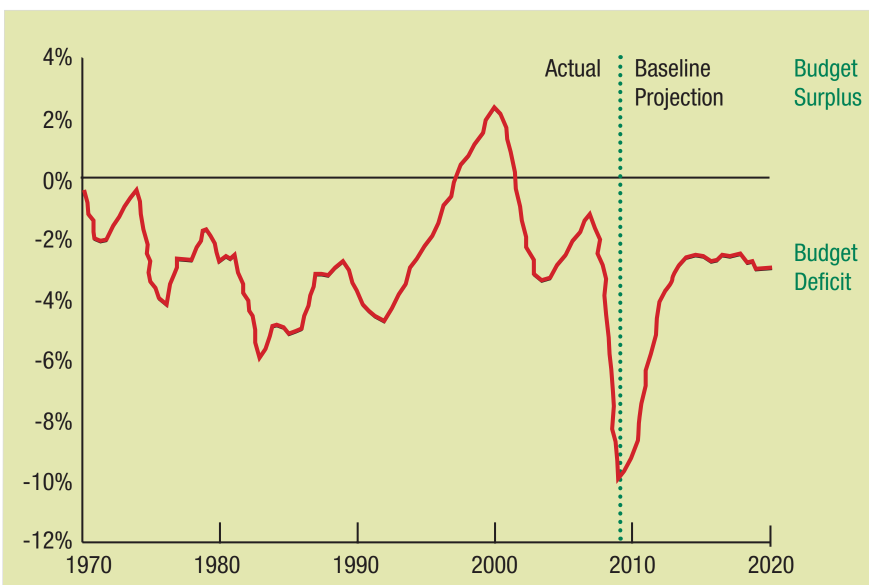
The baseline projection generated by the CBO in January 2010 assumes no changes in current budgetary policy. Why is this important to note? To take the most obvious example, now that health care legislation has been passed by Congress and signed by the President, this could well slow down or even reverse the degree to which the deficit/GDP ratio shrinks in coming years.

And, beyond health care, there are many other bills pending in Congress, which if adopted, will alter government receipts and outlays going forward. Longtime students of the budgetary process, taking note of the mid-term elections on the horizon in 2010 and the political bias towards lower taxes and higher outlays discussed earlier, believe that the projected improvement in the budget deficit as a proportion of GDP, shown in Chart 4, could well be overstated, and result in a ratio that remains at a high level by historical standards.

Chart 4

The Total Deficit or Surplus, 1970-2020

(Percentage of Gross Domestic Product)



Source: Congressional Budget Office

Options for Dealing with the Deficit

With the weight of available evidence suggesting there may be a need to confront the budget deficit once the economy recovers, legislators, commentators, and policy analysts are discussing a number of options.

Do Little or Nothing. Advocates argue the deficit will shrink automatically as the economy recovers and the problems alleged to be associated with large deficits are overstated. Some, who are part of what might be called the "rosy scenario crowd," argue that the economic recovery will be faster and stronger than the CBO is projecting, thereby reducing any dangers on the horizon. Many also point out that raising taxes or cutting spending too soon could abort the recovery and push the economy back into recession.

Raise Taxes. Taking note of President Obama's campaign pledge not to raise taxes on families with total incomes below $250,000, the upcoming mid-term elections, and the usual opposition to tax increases, most observers see this approach as a tough sell.

Cut Spending. While most would support the notion of cutting programs that "don't work" and eliminating any waste, fraud, and abuse from spending programs, few believe that such spending is all that large or, more to the point, all that easy to identify, agree on, and cut. For example, a program element that some believe to be ineffective and wasteful, others often view as essential. For example, many point to the various weapons-building programs the military has wanted to eliminate in recent years but that remain funded because some key legislators fear the effects of such spending cuts on employment in their states.

Appoint a Bipartisan Commission to Recommend Deficit-Reduction Strategies. The political impediments to meaningful deficit reduction policies led a number of elected officials to suggest the appointment of a bipartisan commission to develop recommendations for spending cuts and tax increases and a process for enacting such changes that is politically viable. The president responded to such suggestions by appointing such a Commission on February 18, 2010.

Summary

The budget deficit has skyrocketed because of the 1) automatic, recession-induced increases in government spending, 2) reductions in tax revenues that occurred automatically as the economy plummeted into a serious recession, and 3) the discretionary spending increases and tax cuts enacted to help boost the economy. Aside from the current recession, the tendency of elected officials to resist tax increases and favor increased spending has more often than not produced budget deficits.

The concern is that once the economy recovers, the failure to rein in deficits will have adverse effects on interest rates, economic growth, and on future generations who will have to deal with the consequences. Douglas Elmendorf, the CBO director, summarizes succinctly the budgetary challenges going forward: "The country faces a fundamental disconnect between the services people expect the government to provide, particularly in the form of benefits for older Americans, and the tax revenues that people are willing to send to the government to finance those services. The fundamental disconnect will have to be addressed in some way if the budget is to be placed on a sustainable course." (November 24, 2009)

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