Dēmos

Understanding the National Deficit and Debt: A Primer

OUR FISCAL SECURITY

ABOUT DĒMOS

Dēmos is a non-partisan public policy research and advocacy organization. Headquartered in New York City, Dēmos works with advocates and policymakers around the country in pursuit of four overarching goals: a more equitable economy; a vibrant and inclusive democracy; an empowered public sector that works for the common good; and responsible U.S. engagement in an interdependent world. Dēmos was founded in 2000.

In 2010, Dēmos entered into a publishing partnership with *The American Prospect*, one of the nation's premier magazines focusing on policy analysis, investigative journalism, and forward-looking solutions for the nation's greatest challenges.

ABOUT THE OUR FISCAL SECURITY PROJECT

The Our Fiscal Security project is a collaborative effort of the Economic Policy Institute, Demos, and the Century Foundation. Our institutions are dedicated to promoting an economic path that achieves fiscal responsibility without undermining our national strength. Today, the foundation of that strength – a secure and growing middle class – is being tested by falling incomes, lost wealth, high unemployment and record foreclosures. Yet instead of rebuilding the public structures that could fortify our economy, our elected leaders are facing misguided pressure to reduce the federal budget deficit.

We believe the first priority for our nation is to secure the fundamentals of the economy: strong growth and good jobs. We also believe that in order to reduce our long-term national debt we must refuel the engine of our economy: the middle class. Finally, we strongly oppose the idea that America's fiscal challenges can be solved by cutting longstanding social insurance programs that have brought security and prosperity to millions of Americans. Putting our nation on a path of broad prosperity will require generating new jobs, investing in key areas, modernizing and restoring our revenue base and lowering the costs of our health care system. Achieving these goals, however, will require an informed and engaged public to help set our national priorities.

This brief was compiled and authored by Tamara Draut, Vice President of Policy and Programs, and Robert Hiltonsmith Policy Analyst in the Economic Opportunity Program at Dēmos with research assistance by Becky Theiss at the Economic Policy Institute.

DĒMOS BOARD OF DIRECTORS

Amelia Warren Tyagi, Board Chair
Co-Founder & EVP/COO, The Business Talent Group

Miles Rapoport, President
Dēmos

Mark C. Alexander
Professor of Law, Seton Hall University

Ben Binswanger
Chief Operating Officer, The Case Foundation

Raj Date
Chairman & Executive Director, Cambridge Winter

Maria Echaveste
Co-Founder, Nueva Vista Group

Gina Glantz
Senior Advisor, SEIU

Amy Hanauer
Founding Executive Director, Policy Matters Ohio

Stephen Heintz
President, Rockefeller Brothers Fund

Sang Ji
Partner, White & Case LLP

Clarissa Martinez De Castro
Director of Immigration &
National Campaigns, National Council of La Raza

Rev. Janet McCune Edwards
Presbyterian Minister

Arnie Miller
Founder, Isaacson Miller

John Morning
Graphic Designer

Wendy Puriefoy
President, Public Education Network

Janet Shenk
Senior Program Officer, Panta Rhea Foundation

Adele Simmons
Vice Chair, Chicago Metropolis 2020

David Skaggs
Former Congressman

Paul Starr
Co-Editor, The American Prospect

Ben Taylor
Chairman, The American Prospect

Ruth Wooden
President, Public Agenda

Members, Past & On Leave

President Barack Obama
Tom Campbell
Christine Chen
Juan Figueroa
Robert Franklin
Charles R. Halpern
Sara Horowitz
Van Jones
Eric Liu
Spencer Overton
Robert Reich
Linda Tarr-Whelan
Ernest Tollerson

Affiliations are listed for identification purposes only.

As with all Dēmos publications, the views expressed in this report do not necessarily reflect the views of the Dēmos Board of Trustees.

INTRODUCTION

Concerns about rising budget deficits have been on the political scene for decades. More recently these concerns have reappeared, as tax cuts and the costs of two wars transformed budget surpluses left by President Clinton into deficits in the early 2000s, while foreseeable long-term challenges approached. More recently, the recession has increased the short-term deficit to historic levels, though they will come down as the economy recovers. The current federal debt, which has risen sharply as tax cuts were phased in over a decade, security spending soared, and the nation was devastated by the financial crisis, is at its highest level since 1952, when the country was still repaying debt incurred during World War II.[1] However, sharp increases in deficits and debt are common during economic downturns due to declines in tax receipts and additional federal spending to ameliorate the negative effects of a recession. Similarly, the deficit and national debt are most commonly measured as a share of the economy, so a shrinking economy also makes the fiscal outlook worse.

The current debate over our nation's fiscal future is, however, conflating large short-term deficits, which will drop significantly after the recession, with the longer-term outlook for rising debt which is driven by escalating health care costs and an antiquated revenue code.[2] Understanding the difference between short-term cyclical effects and long-term structural imbalances—and the main factors of each type of shortfall—is critical to adopting the right policy response. This short brief will give an overview of the concepts of the deficit and public debt, their causes and impacts on the national economy, and the appropriate policy options to address them in the short-, medium-, and long-term.

DEFICIT

The federal budget deficit is simply the difference between government revenues, or the amount of money taken in by the government, and spending. If the government spends more money than it takes in, the budget of the government is said to be in deficit; if it takes in more money than it spends, the difference is called a surplus.

During economic downturns, the deficit typically rises, as higher unemployment translates into lower tax revenues. For example, by the time President Obama was sworn into office in January 2009, thirteen months of recession had pushed the deficit to over $1 trillion. The federal government usually increases spending temporarily during severe economic downturns, creating a stimulus effect by offsetting contraction of the private sector and state governments. The American Recovery and Reinvestment Act of 2009 included $499 billion of stimulus spending (grants, contracts, loans and entitlement spending) and $288 billion of tax cuts over two years.[3] The deficit effect of these temporary measures will largely disappear, however, at the end of this year.

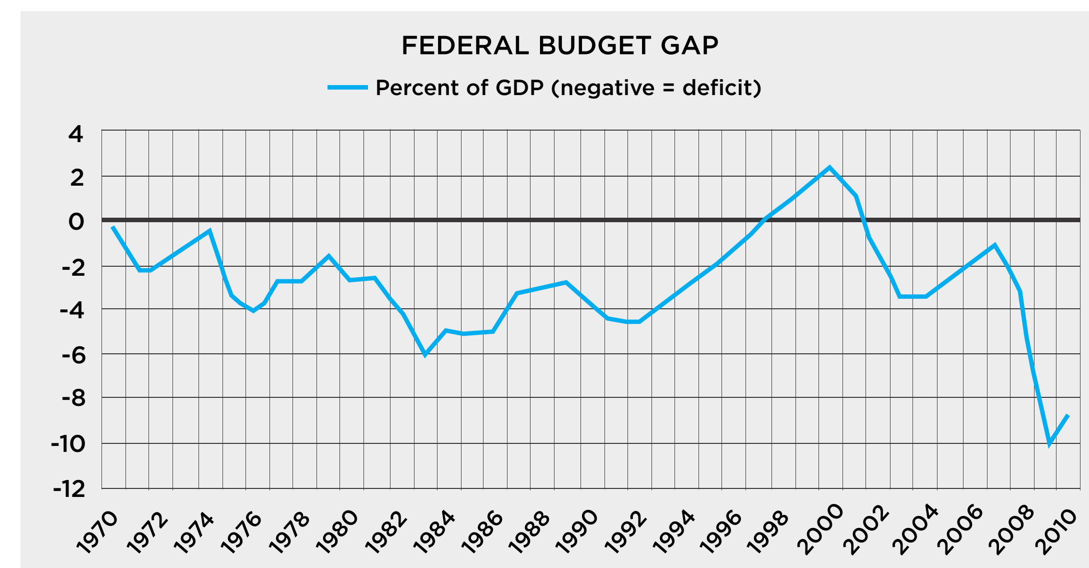
For each year the federal government has a budget deficit, it must borrow the amount of the difference between spending and revenues from external sources: individuals, private businesses, or foreign countries. The government does this by selling Treasury bonds, which guarantee a fixed payment, known as interest, to the creditor in exchange for borrowing the sum of money. In February 2011, the long-term yield on a Treasury bill was 1.65 percent, demonstrating strong demand for U.S. government debt despite our fiscal situation.[4]

DEBT

The federal debt is the cumulative amount borrowed by the government; the annual change in the debt is approximately equal to the budget deficit or surplus. Each year the government runs a deficit it adds to the debt, and each year it runs a surplus the debt decreases. In actuality, the federal government not only borrows from external sources, but from itself as well. The government has several trust funds, including those of Social Security and Medicare, for programs whose revenues are largely separate from the rest of the federal budget. When these programs run surpluses, they are invested in a special type of Treasury bond; the Treasury Department invests these funds in turn in various current government programs. The entire stock of government debt, including that owed to other government programs, is called gross debt, while that owed to external sources—the public—is called net debt. Net debt, or debt held by the public, is the measure that most analysts and the media describe when they speak about the federal debt in general terms, and is the number most economists agree is relevant when discussing the potential economic impacts of government debt.[5] The debt held by the public stood at 62.1 percent of GDP in 2010 and is projected to rise to 69.4 percent of GDP in this year.[6]

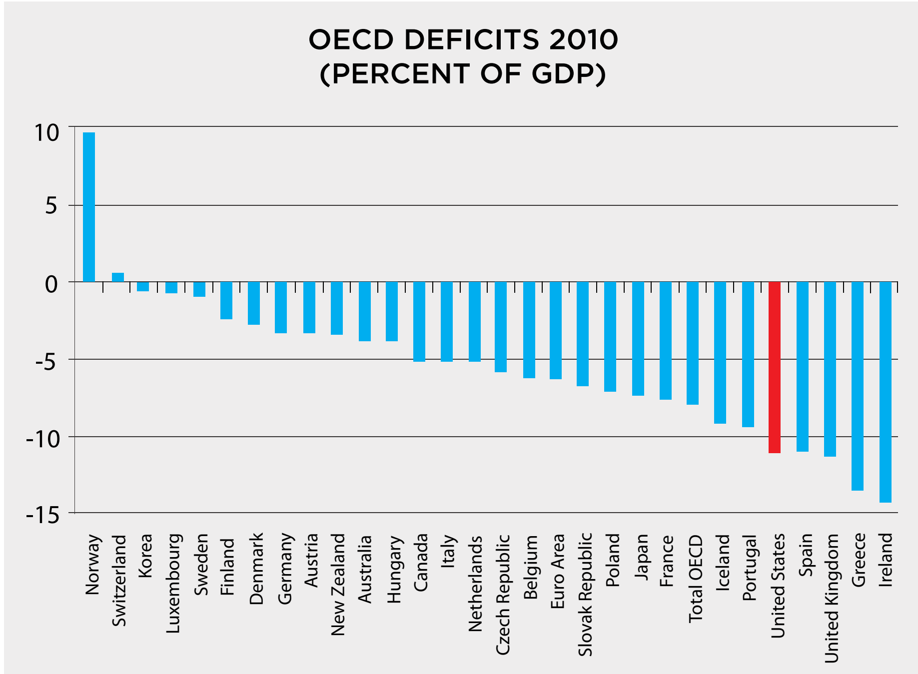
In themselves, deficits and debts are neither good nor bad; individuals, businesses, and countries all choose to borrow for various purposes, whether to make a large-ticket purchase such as a house or factory, or to help cover expenses during economic downturns or other emergencies. Since the end of World War I, the United States public debt has varied widely - ranging from 15 percent of GDP to 113 percent of GDP – without investors ever losing faith in the creditworthiness of our nation. Borrowing money for a productive purpose, such as investing in education or infrastructure, often pays off over a long time horizon. However, if substantial debt accumulates, the interest on the borrowed money can start to become an onerous or even unsustainable burden, not to mention the burden of paying down the debt itself. The deficit and debt have varying short-, medium-, and long-term implications for the health of our economy; however, the causes and magnitude of these differ widely, requiring different policy prescriptions for each.

THE DEFICIT: SNAPSHOT AND HISTORICAL TRENDS

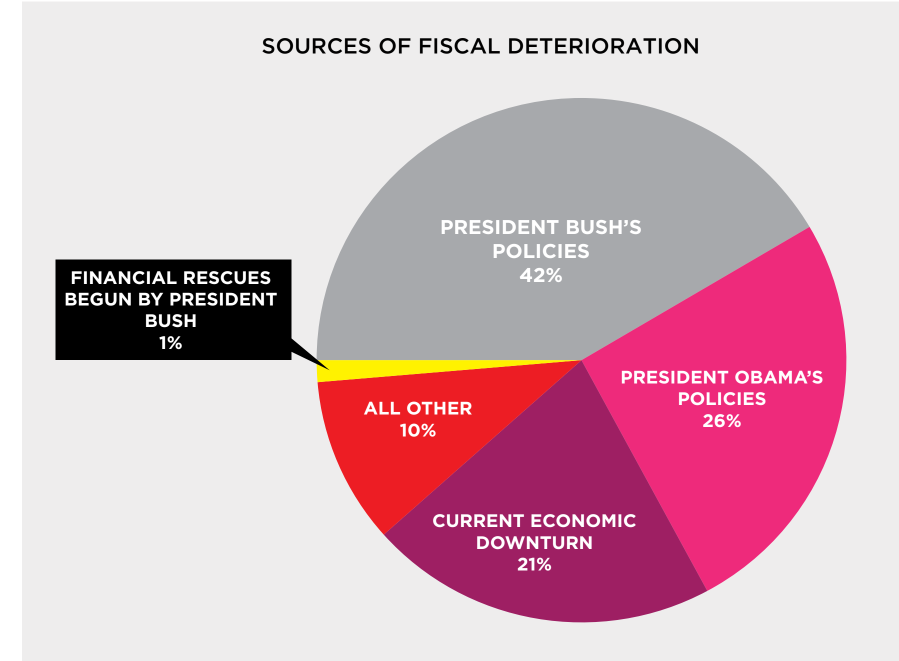


Source: CBO, The Budget and Economic Outlook: Fiscal Years 2010 to 2020, Table F-2

While our current deficit is indeed the second-largest the country has faced in 65 years, the deficit must be understood in context: the economy remains mired in the aftermath of the worst financial crisis and recession since the Great Depression. The deficit is caused by both a sharp drop in tax revenues from their pre-recession level of 18.5 percent of GDP in 2007 to 14.9 percent in 2010, as well as a rise in spending from 19.6 percent to 23.8 percent during the same period.[7] While this indeed seems large, deficits only impact future economic growth if they are sustained at high levels, rather than if they are temporary results of an economic crisis. A comparison to other industrialized countries suggests the latter explanation; most of the countries in the OECD ran large deficits in 2010.[8]



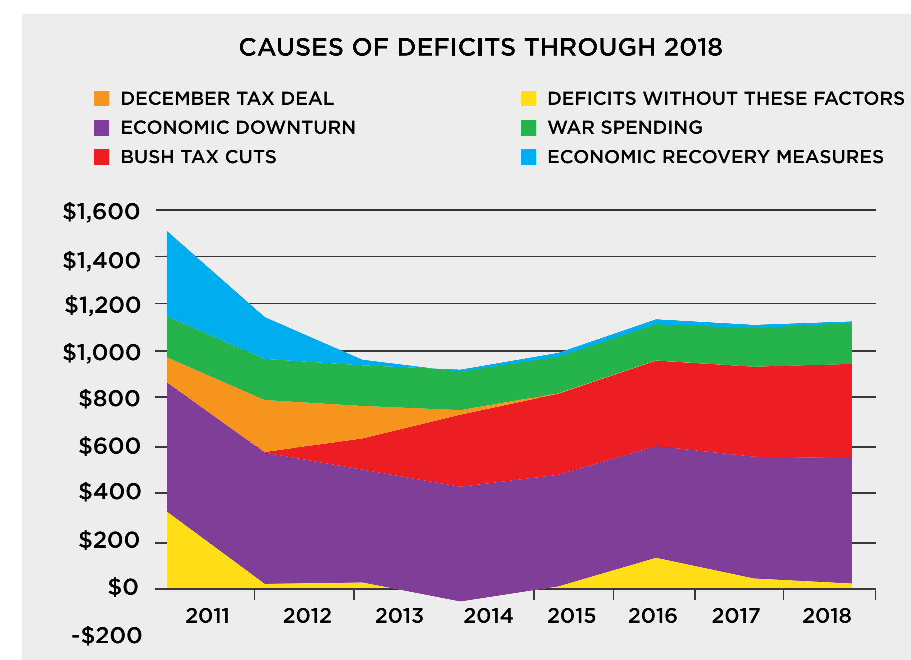
Source: OECD, Economic Outlook No. 87 database, Table 27.



Note: President Obama's policies do not include the cost of the upper-income tax policies included in the December tax deal.
Source: EPI analysis of CBO data.

Sources of the Current Deficit. The FY 2011 deficit, according to CBO's current law baseline, will be around $1.4 trillion. While measuring the exact makeup of this deficit is nearly impossible, we are able to pinpoint factors that have contributed to the current fiscal deterioration – that is, the swing from the projected surpluses we saw at the beginning of President Bush's administration, to the deficits we are seeing now. The fiscal deterioration between the beginning of President Bush's administration and the current FY 2011 budget picture can be attributed to a number of factors. President Bush's policies, including the upper-income tax cut portion of the December 2010 tax deal (an extension of Bush policy), account for just above 40% of the fiscal deterioration in 2011. President Obama's policies, such as extending unemployment insurance benefits and boosting stimulus spending in a depressed economy, are responsible for just 26 percent of our current budgetary state. Another 21 percent is due to the economic downturn, while the rest of the fiscal deterioration can be attributed to economic and technical adjustmetns as identified by the CBO before the economic downturn began.

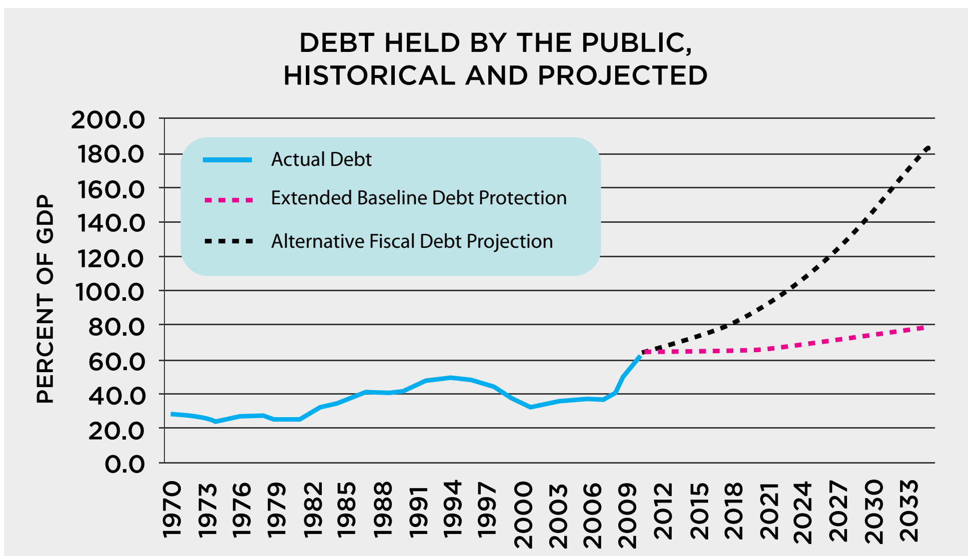
Though the effects of the downturn on the federal budget will dwindle rapidly in the next few years as programs wind down and the economy recovers, recent Congressional Budgetary Office (CBO) estimates predict that the debt held by the public will still rise to 87 percent of GDP by 2020 absent tax and/or spending reforms.[9] The draining effect of tax cuts on revenues, as well as the continuing effects of the economic downturn are the largest contributors to continuing projected deficits through 2018, as the chart below illustrates. Addressing revenue inadequacy – and its effect on projected deficits and rising debt in the country – is essential for our nation's fiscal future.



Source: EPI analysis of CBO data.

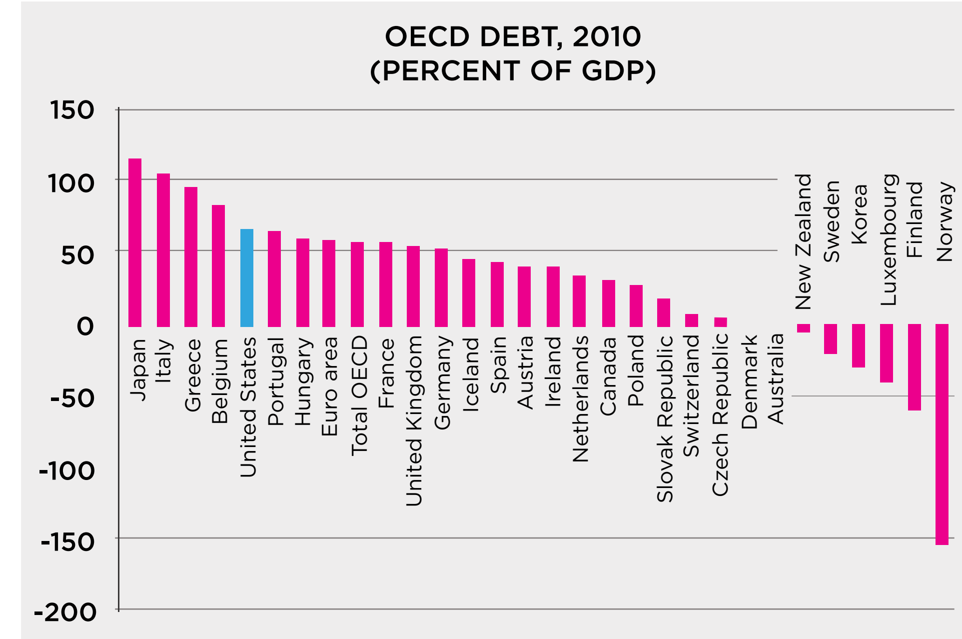
THE NATIONAL DEBT: SNAPSHOT AND HISTORICAL TRENDS

Though there is no consensus on the maximum level of debt that the U.S. economy can sustain, we are certainly not at that level now. Publicly-held debt was 113 percent of GDP at the end of the World War II, [10] and in the decade afterward, the economy grew rapidly, lowering the debt as a share of the economy.[11] In fact, rising debt is usually a symptom, rather than a cause, of economic distress: when the economy contracts, revenue falls and debt held by the public rises relative to national income.[12] While an economic shock, such as the Great Recession or Great Depression, can result in a temporary surge in debt, structural fiscal problems or sustained slow economic growth can also result in a continuous rise in public debt. The projected rise in debt over the next decade is not the result of a sudden burst of irresponsible federal spending, but a combination of historically irresponsible fiscal policy and external influences on the budget of the federal government. Over the next decade, the primary drivers of increasing debt are the Bush-era tax cuts that significantly reduced government revenues, rising interest payments on the public debt, a projected continuation of overseas military operations, and continued fallout from the recession.[13]



Source: CBO, The Long Term Budget Outlook, Figure 1-2. The major difference between the Alternative and Extended Baseline Projections is the extension of the Bush Tax Cuts.

Once again, comparisons to other similarly-developed countries put the U.S. debt burden in perspective. Japan has nearly twice the debt level of the U.S., and that of many other countries, including France and the United Kingdom, approaches it.[14] Excessive debt can affect the economy through one major channel. First, the higher the debt, the higher the interest paid on it. If we assume that the government is unwilling to raise taxes to accommodate higher interest payments, this interest crowds out other government spending by reducing the pool of funds available for non-interest expenditures. While large deficits have often increased costs of government borrowing, leading to rising bond yields, the yields on Treasury notes are currently near-historic lows. If anything, the bond market is signaling that it wants more fiscal stimulus.

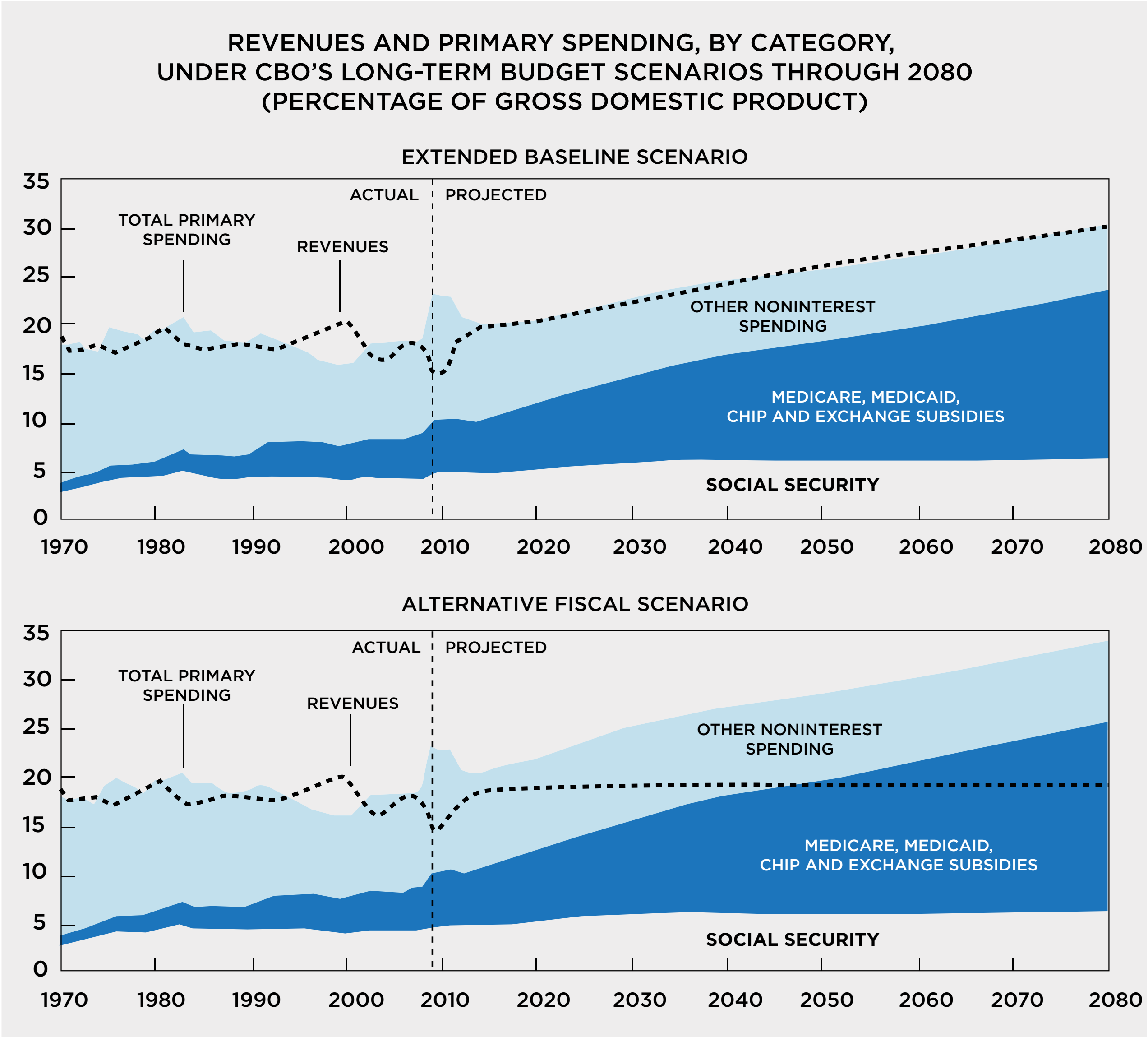


Source: OECD, Economic Outlook No. 87 database, Table 27.

While the current interest payments on the debt, at $225 billion or 1.5 percent of GDP per year,[15] consume only a small portion of both the federal budget and national income, they will become a crippling burden if debt increases at the rate projected under the CBO's Alternative Fiscal Scenario (extended Bush tax cuts), reaching 3.8 percent of GDP by 2020 and 8.7 percent in 2035.[16] It is apparent that the long-term causes of the debt need to be addressed if we want to continue to fund national priorities and see continued economic growth.

THE LONG-TERM DEBT PROBLEM

Before we enumerate the actual long-term causes of projected rising debt, it is important to clearly note a few common culprits that are not among those causes. The economic recovery measures, the ARRA and TARP, are simply short-term expenses: their effect on the deficit largely disappears by the end of 2011.[17] Social Security is also a small part of the long-term debt picture. Its total shortfall is projected to be 0.6 percent of total GDP over the next three-quarters of a century ,[18] a small effect on the budget compared to the economic downturn and the Bush-era tax cuts which will, over the next decade, consume 2.1 percent and 2.6 percent of GDP respectively.[19] However, these are not the only factors driving the projected debt increase. In fact, even if the Bush-era tax cuts were entirely repealed and the effects of the downturn completely mitigated, the federal government would still be facing deficits and rising debt into the indefinite future. The other primary cause of the country's long-term fiscal imbalance is the rapidly rising cost of health care. The United States already spends nearly twice as much on health care as a share of GDP as most of its international peers;[20] a share that will only rise as costs continue to spiral out of control. This continued cost explosion significantly affects the federal budget, primarily since Medicare and Medicaid would consume an increasing share of the country's GDP. The same CBO estimates project that federal spending on health care, currently 5.5 percent of GDP, will soar to 7.2 percent by 2020 and 10.9 percent by 2035.[21] Any long-term solution to the country's fiscal distress must include proposals to control health care costs among others.



Source: Congressional Budget Office.

STABILIZING DEBT: SHORT-, MEDIUM-, AND LONG TERM POLICY

SHORT-TERM

Sending the economy back into recession would be the worst thing we could do for our fiscal outlook. To ensure that our country returns to the level of sustainable economic growth necessary to successfully tackle our fiscal challenges, **economic recovery must take priority over deficit reduction in the short-term.** This does not, however, mean ignoring our long-term challenges at present. The recent health care reform legislation is a prime example of how to tackle our long-term fiscal challenges without trimming the near-term budget deficit and stalling the economic recovery. In the next few years, the country should adopt the following broad guidelines as it recovers:

- *No deficit reduction until full recovery.* Until the private sector has recovered, any cuts in public spending will simply translate into slower growth for the economy as a whole and a slower return to more normal levels of employment. Therefore, deficit reduction should be off the table until the economy has fully recovered. We support a 6-for-6 trigger: the economy should achieve an unemployment rate lower than six percent for six consecutive months.

- *Job creation as the first priority.* Jobs and economic growth are essential to our capacity to reduce deficits. Efforts to spur job creation today will put us on a better economic path and create a solid revenue base.

- *Revenue sharing with the states.* Not only must the federal government create jobs, but it should support states with ailing budgets to help them avoid devastating job cuts. If states with budget shortfalls continue to slash their payrolls to meet balanced budget requirements, the job cuts will hinder the country's return to growth just as much as if the federal government failed to create jobs itself.

MEDIUM-TERM

- *Strengthen Social Security and retirement security.* Ensuring that all workers enjoy a secure and adequate retirement is a necessary part of rebalancing our fiscal priorities. Maintaining or increasing Social Security benefits ensures that retirees will have a guaranteed income stream, which in turn stabilizes the economy during recessions. Reforming the individual retirement system is also critical for this goal. Without secure benefits to supplement Social Security, most workers could not afford to retire. Finally, the current system of tax preferences for retirement savings must be examined to ensure that government is promoting retirement security as efficiently as possible.

- *Replenish federal government revenues and modernize the tax code.* Restoring government revenues to adequate levels is critical to support the programs and make the investments in our country that the private sector is unable to provide. By closing tax loopholes, altering the portions of the tax code that largely benefit the wealthy, and looking for untapped revenue sources such as a carbon tax, we can secure the capital necessary to fund vital federal programs.

- *Reassess national security goals and budget.* The United States' budget for national security is larger than the combined budgets of the rest of the world. A national task force has identified over $1 trillion in defense spending that could be eliminated over a decade without jeopardizing national security.[22] By making appropriate, responsible reductions in the defense budget, we can free up funds for other critical areas including deficit reduction.

LONG-TERM

- *Curb the rise in health care costs.* Over the past decades, health care costs in the United States have risen at over twice the average rate of other developed nations. These cost increases are excessive and largely caused by the perverse incentives of the "fee for service" payment system and lack of competition in the medical sector. The recently passed health care reform will slow the rate of these increases, but further reform will be necessary to prevent government spending on medical services from taking up a prohibitively large portion of the budget. Further changes should wait until we can determine the successes of health care reform, but enacting a strong public option to compete with private insurers and buy drugs and services in bulk would be a strong next step to containing costs.

- *Close the public investment deficit.* For decades, federal spending on critical human and physical capital has been decreasing. Government investments in education, transportation, and energy infrastructure have fallen as a share of GDP as revenues have shrunk and other areas, including defense, have eaten up increasing shares of the budget. New schools, a modern energy grid, and a green transportation network are among the many critical investments necessary to ensure our country's future growth.

ENDNOTES

1. Congressional Budget Office (CBO), Historical Federal Debt, January 2010, http://www.cbo.gov/doc.cfm?index=11766; Congressional Budget Office (CBO), The Budget and Economic Outlook: An Update, August 2010, http://www.cbo.gov/doc.cfm?index=11705.

2. David Rosnik and Dean Baker, "Taming the Deficit: Saving our Children From Themselves," Center for Economic and Policy Research (CEPR), December 2009.

3. Recovery. Gov, "Overview of Funding," last accessed March 24, 2011, http://www.recovery.gov/pages/textview.aspx?List={EB595CCA-D93F-48F4-AF96-11E2D41DE73D}&xsl=Charts/FundingOverviewChartTextView.xsl

4. U.S. Treasury, "Daily Treasury Real Long-Term Rates," accessed March 24, 2011.

5. John Irons and Josh Bivens, Government Debt and Economic Growth, Economic Policy Institute (EPI), Briefing Paper 271, July 26, 2010, http://epi.3cdn.net/d144a03f5b38f7a137_aqm6b9p0y.pdf.

6. Congressional Budget Office (CBO), The Budget and Economic Outlook, Fiscal Years 2011 to 2021, January 2011, http://www.cbo.gov/doc.cfm?index=12039.

7. Office of Management and Budget (OMB), Historical Tables, Table 1.2-Summary of Receipts, Outlays, and Surpluses or Deficits (-) as Percentages of GDP: 1930-2015, op. cit.

8. Organization for Economic Co-operation and Development (OECD), "OECD Factblog Deficit Data," March 23, 2010 (See comment on page 3).

9. Congressional Budget Office (CBO), "The Long-Term Budget Outlook," August 2010, http://www.cbo.gov/doc.cfm?index=11579.

10. CBO, Historical Federal Debt, August 2010, op. cit.

11. Josh Bivens and Anna Turner, "Putting Public Debt in Context," Economic Policy Institute (EPI), Briefing Paper 272, August 3, 2010.

12. John Irons and Josh Bivens, op. cit.

13. Kathy A. Ruffing and James R. Horney, op. cit.

14. OECD Economic Outlook 87 database.

15. Congressional Budget Office (CBO), The Budget and Economic Outlook, op. cit.

16. Congressional Budget Office (CBO), The Long-Term Budget Outlook, op. cit.

17. Kathy A. Ruffing and James R. Horney, op. cit.

18. Social Security Administration, "The 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds", August 10, 2010, http://www.socialsecurity.gov/OACT/TR/2010/tr10.pdf.

19. Kathy A. Ruffing and James R. Horney, op. cit.

20. OECD, "OECD Health Data 2010," June 2010, http://www.oecd.org/document/16/0,3343,en_2649_34631_2085200_1_1_1_1,00.html.

21. CBO, "The Long-Term Budget Outlook," August 2010, http://www.cbo.gov/doc.cfm?index=11579.

22. The Sustainable Defense Task Force, Debts, Deficits, and Defense: A Way Forward, The Commonwealth Institute, http://www.comw.org/pda/.

23. The change in the debt is not necessarily equal to the deficit because of accounting methods used for a few unconventional means of financing programs or obligations, such as loan expansions and disbursements on loan guarantees.

24. These estimates refer to general government deficits, meaning the total deficits of state, local, and federal government, which is meant as a better international comparison. See note on Annex Table 25: http://www.oecd.org/dataoecd/5/51/2483816.xls

CONTACT

Dēmos
220 Fifth Avenue, 5th Floor
New York, New York 10001
Phone: (212) 633-1405
Fax: (212) 633-2015
www.demos.org
info@demos.org

Media inquiries:
Tim Rusch, *Communications Director*
trusch@demos.org
212-389-1407

OUR FISCAL SECURITY

Dēmos

220 Fifth Ave., 2nd Floor | New York, New York 10001 | 212.633.1405
www.demos.org