The MISSOURI BUDGET PROJECT
Shaping Policy... Creating Opportunities

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Background on the National Deficit and Long-Term Debt, a Primer

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The federal deficit continues to consume a large portion of our national resources. At nearly 10 percent of gross domestic product (GDP), the deficit for fiscal year 2009 was the largest since the end of World War II. Still, it is not unprecedented. Historically, deficit spending grows in times of war and in times of economic recession.

However, the long-term consequences of the national deficit are of significant concern because they add to the nation's long-term debt. When analyzing policies to address both the short-term deficit and long-term debt, it is important to draw a clear distinction between the two. It is the growing federal debt that poses the greatest threat to our long-term economic prospects. The Congressional Budget Office projects that, if left unattended, the national debt will equal *at least* 80 percent of the Gross Domestic Product by 2035.[i]

Policy options to address each must incorporate a balanced approach that does not jeopardize current economic recovery. Crafting this balance begins with an understanding of how deficits function as an aid for national recovery, how deficits have been reduced in the past, as well as how those historical dynamics apply to our current situation.

Background: Historical Patterns of Deficits and the U.S. Debt

Deficits and debt are clearly related. The term "deficit" relates to government expenses that exceed revenues within a given year. When that occurs, the government borrows money to pay what it owes. Payments on those loans constitute the nation's long-term public debt. Several consecutive years of deficits add to the national debt. In turn, payments on that debt become a growing part of the federal budget.

The table at right shows that both deficits and gross debt rise in times of war and in times of economic distress. After both world wars, deficits quickly turned to surpluses. In the years since, the nation has run relatively low federal deficits, interrupted by brief periods of surplus. Debt levels during that time have ranged from a low of 31.8 percent in 1981 to the high levels reached today.

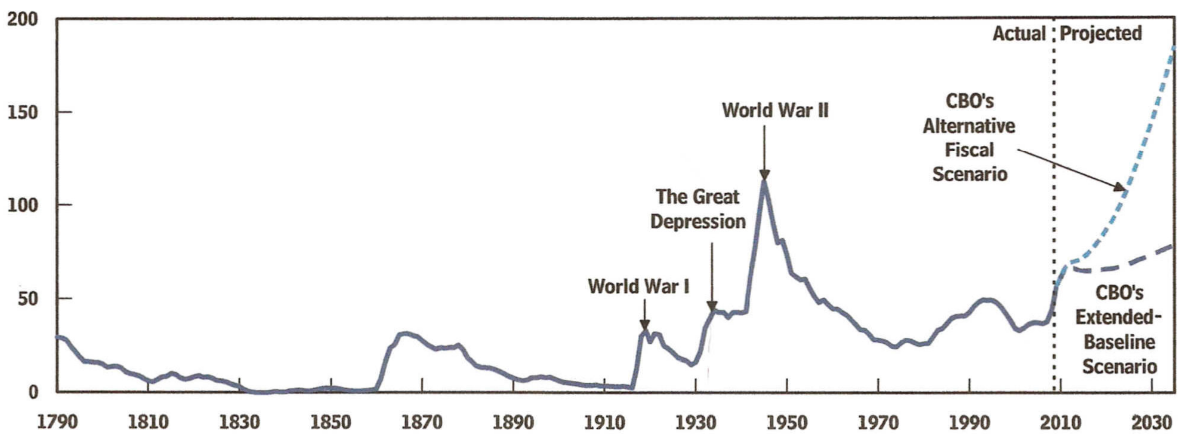
Historical Comparison of Deficits and Debt
(as a percentage of GDP)[ii]

	Deficit-to-GDP	Debt-to-GDP
World War I	16.9%	35.0%
Great Depression	4.8%	40.3%
World War II	28.0%	116.0%
FY 2009	9.9%	53.0%
FY 2010	8.9%	62.3%

The graph below shows that current debt levels will continue to rise, after a brief dip. **These Congressional Budget Office (CBO) projections show that federal debt will be 62 percent of gross domestic product (GDP) by the end of fiscal year 2010, the first time since World War II that federal debt has exceeded 50 percent of GDP.** [iii]

Federal Debt Held by the Public, 1790 to 2035

(Percentage of gross domestic product)



Source: Congressional Budget Office, *The Long-Term Budget Outlook* (June 2010); *Historical Data on Federal Debt Held by the Public* (July 2010).

Note: The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2020 (with adjustments for the recently enacted health care legislation) and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period.

Background: The Driving Factors of the Current Deficit

Periods of sharp increases in the national deficit generally coincide with increased expenses incurred during times of war. Deficit spending also rises in periods of economic depression. Deficit spending during these times is used to stabilize and hasten economic recovery.

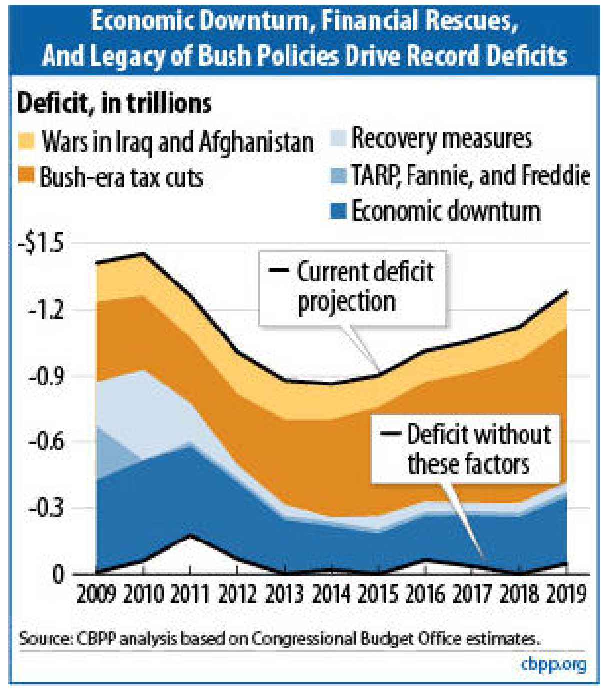
Over the last decade the U.S. has increased spending for wars in Afghanistan and Iraq. More recently, the economic downturn caused revenues to decline, at the same time that increased government spending was required to stabilize the economy. According to the Congressional Budget Office, "The recent increase in debt has been the result of three sets of factors:

- An imbalance between federal revenues and spending that predates the recession and the recent turmoil in financial markets,
- Sharply lower revenues, and
- Elevated spending that derives directly from those economic conditions and the costs of various federal policies implemented in response to the conditions."[iv]

A closer look at the components shows that large portions of the deficit can be attributed to several broad categories. The chart below shows how various factors contribute to the current situation.

According to CBO data analyzed by the Center on Budget and Policy Priorities,

- Economic deterioration "accounts for over $400 billion of the deficit each year in 2009 through 2011 and slightly smaller amounts in subsequent years…much of it in the form of additional debt-service costs…"[v]
- Economic recovery measures, including ARRA, "account for $1.1 trillion in deficits over the 2009-2019 period (including the associated debt service). Their effects are highly concentrated in 2009 through 2011 and fade thereafter, delivering a boost to the economy during its most vulnerable period…
- Tax cuts and the wars in Iraq and Afghanistan accounted for over $500 billion of the deficit in 2009 and will account for almost *$7 trillion* in deficits in 2009 through 2019, including the associated debt-service costs". [vi]



In the short term, deficits aid economic recovery. Increases in government spending and reductions in taxes "usually increase overall demand for goods and services, which leads firms to boost their output and hire more workers."[vii] However, there are long-term consequences, including the erosion of federal spending capacity due to higher interest payments on the debt, crowding out of private investments due to increased government borrowing, and the potential to reduce the United States' ability to respond to other critical situations, including any future fiscal crises.

Regardless of the need for short term deficit spending, there is general agreement among policy makers and economists that the current deficit is unsustainable.

Impact on the National Debt and Future Projections

In projecting future debt levels, the CBO provides two alternative scenarios (pictured in graph one on page 2): an Extended Baseline Scenario and an Alternative Fiscal Scenario.

The Extended Baseline scenario assumed that the laws in place as of July 2010 will continue, including the implementation of health care reform and the expiration of Bush-era tax cuts. Continuation of current law leads to a near-term dip, followed by a short period of relative stability. It is then assumed that increases in spending for Social Security and other needs will "…cause deficits to increase, and debt would once again grow faster than the economy." By 2035, the debt would equal about 80 percent of GDP.[viii]

In the Alternative Fiscal scenario, the CBO assumed certain changes to existing law, including the extension of the Bush-era tax cuts. The extension did, in fact, occur in December 2010. The Alternative scenario also includes changes that are expected *but not yet certain*, like an adjustment of the "alternative minimum tax" and increases in Medicare payments. This results in a sharply higher rate of debt growth, reaching 180 percent of GDP by 2025. It is generally agreed that this level of debt is unsustainable. [ix]

Summary

Fiscal sustainability requires that the nation implement policies to create a stable debt-to-GDP ratio. Reducing the deficit is one component of stabilizing debt, but it is not the only factor. It is possible to stabilize the debt while still running reasonable short-term deficits. Deficit spending that supports the emerging economic recovery will lead to increases in the GDP that, in turn, improve the debt-to-GDP ratios.

Stabilizing the debt will also require some hard choices for the nation in the medium-term to ensure that increases in spending do not grow faster than GDP. Those choices are critical if we are to achieve a sustainable debt level in the long-term.

This paper explained how deficits function as an aid for national recovery, the factors behind the current deficit, and projections for future debt levels. Opinions vary as to how that is best achieved, as evidenced by several proposals that have recently been introduced. Proposals for addressing deficits and debt levels will be analyzed in a separate paper.

[i] Congressional Budget Office. (2010). Federal Debt and the Risk of a Financial Crisis, Economic and Budget Issue Brief, July 27, 2010. Retrieved from: http://www.cbo.gov/ftpdocs/116xx/doc11659/07-27_Debt_FiscalCrisis_Brief.pdf, February 2011.

[ii] Data for World War I, Great Depression and World War II compiled from historical data on federal deficits and gross public debt, Retrieved from: www.usgovernmentspending.com, February 2011; Data for FY 2009 and FY 2010 from Ruffing, K, Cox, K. & Horney, J. The Right Target: Stabilize the Federal Debt. Center on Budget and Policy Priorities, January, 12, 2010. Retrieved from: www.cbpp.org, February 2011. Debt figures are for publicly held debt only and do not include monetarized debt or debt held by the federal government.

[iii] Congressional Budget Office. (2010). Federal Debt and the Risk of a Financial Crisis, Economic and Budget Issue Brief, July 27, 2010. Retrieved from: http://www.cbo.gov/ftpdocs/116xx/doc11659/07-27_Debt_FiscalCrisis_Brief.pdf, February 2011.

[iv] Ibid.

[v] Ruffing, K. & Horrney, J. Critics Still Wrong on What's Driving Deficits in Coming Years. Center on Budget and Policy Priorities, June 28, 2010. Retrieved from: http://www.cbpp.org/cms/index.cfm?fa=view&id=3036#_ftn6 , February 2011.

[vi] Ibid.

[vii] Congressional Budget Office. (2010). Federal Debt and the Risk of a Financial Crisis, Economic and Budget Issue Brief, July 27, 2010. Retrieved from: http://www.cbo.gov/ftpdocs/116xx/doc11659/07-27_Debt_FiscalCrisis_Brief.pdf, February 2011.

[viii] Ibid.

[ix] Ibid.