4. Deficits and the Debt

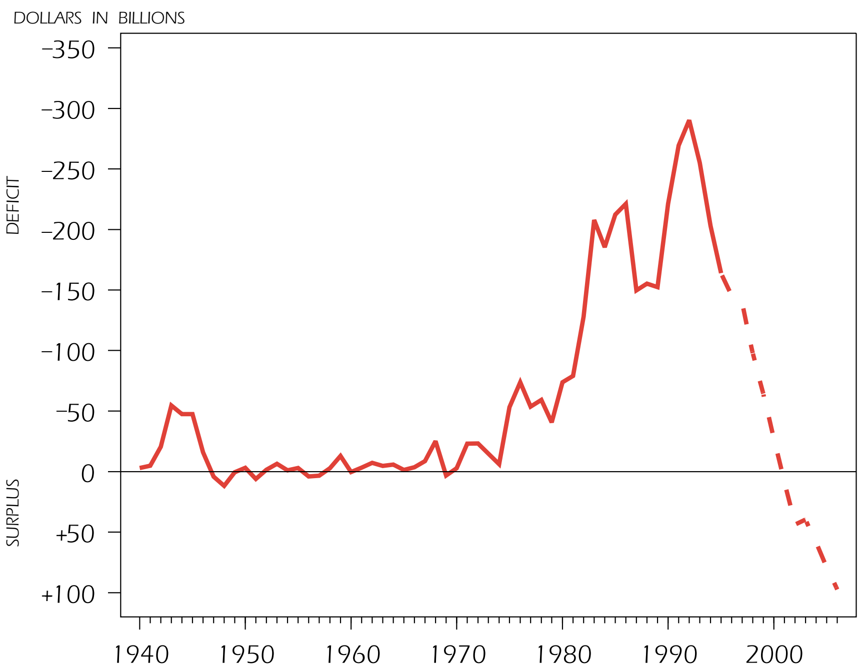
You've probably heard a lot about the Federal budget deficit and debt in recent years, primarily because both exploded in size in the 1980s.

Put simply, a *deficit* occurs when spending exceeds revenues in any year—just as a surplus occurs when revenues exceed spending. Generally, to finance our deficits, the Treasury borrows money. The *debt* is the sum total of our deficits, minus our surpluses, over the years.

The deficit is not a new phenomenon; the Government incurred its first in 1792, and it generated 68 annual deficits between 1900 and 1995.

Chart 4–1 provides the history of budget surpluses and deficits since 1940.

Chart 4–1. Past and Future Budget Deficits or Surpluses



Deficits began increasing dramatically in the 1980s, but have begun to decline. The President's budget is designed to bring the budget into balance over the next seven years.

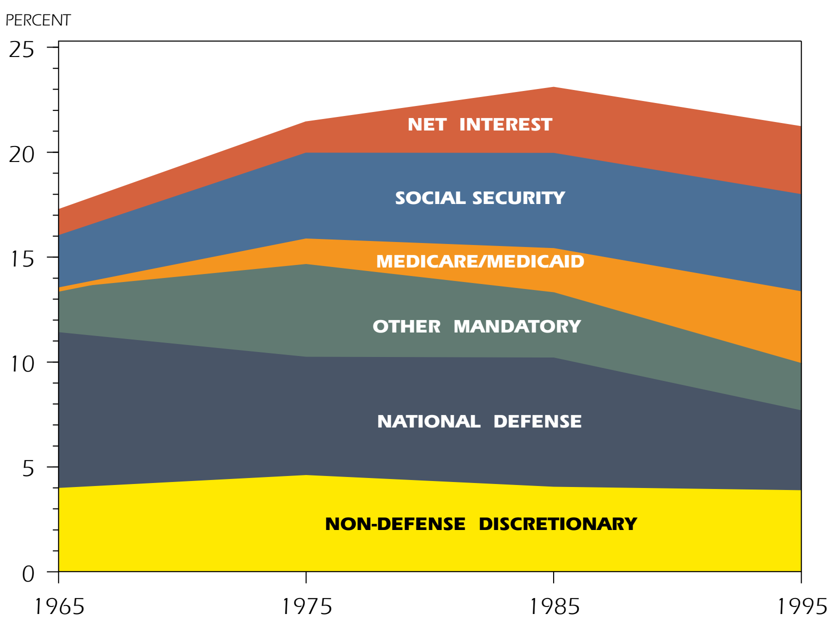
For most of the Nation's history, deficits were the result of either wars or recessions. Wars necessitated major increases in military spending, while recessions reduced Federal tax revenues from businesses and individuals.

The Government generated deficits during the War of 1812, the recession of 1837, the Civil War, the depression of the 1890s, and World War I. Once the war ended or the economy began to grow, the Government followed its deficits with budget surpluses, with which it paid down the debt.

Deficits returned in 1931 and remained for the rest of the decade—due to the Great Depression and the spending associated with President Roosevelt's New Deal. Then, World War II forced the Nation to spend unprecedented amounts on defense and to incur unprecedented deficits. Since then—with Democratic and Republican Presidents, Democratic and Republican Congresses—the Government has balanced its books only eight times, most recently in 1969.

Why have deficits become such a perennial problem for budget decisionmakers? Because spending has been growing faster than revenues.

Chart 4–2. Outlays as a Percent of GDP



Between 1965 and 1995, spending on Social Security, Medicare and Medicaid, and interest as a percentage of GDP grew, while spending on defense fell.

Revenues have stayed relatively constant, at around 19 percent of GDP, since the 1960s. In that time, however, outlays have grown from below 18 percent of GDP in 1965 to up to 24 percent in 1983 before falling to 21 percent today. Much of the spending growth has come in Social Security, Medicare, Medicaid, and interest payments (see Chart 4–2).

Nevertheless, the deficits before 1981 paled in comparison to what followed. That year, the Government cut income tax rates and greatly increased defense spending, but it did not cut non-defense programs enough to make up the difference. Also, the recession of the early 1980s reduced Federal revenues, increased Federal outlays for unemployment insurance and similar programs that are closely tied to economic conditions, and forced the Government to pay interest on more national debt at a time when interest rates were high. As a result, the deficit soared.

Why the Deficit is a Problem

The United States is not alone in struggling with budget deficits. As Chart 4–3 illustrates, this Nation has an average record when compared to the recent history of six other major developed economies. (To make accurate comparisons with the governments of other nations, the U.S. data include the activities of State and local governments).

If budget deficits occur so frequently, here and abroad, should we worry about them?

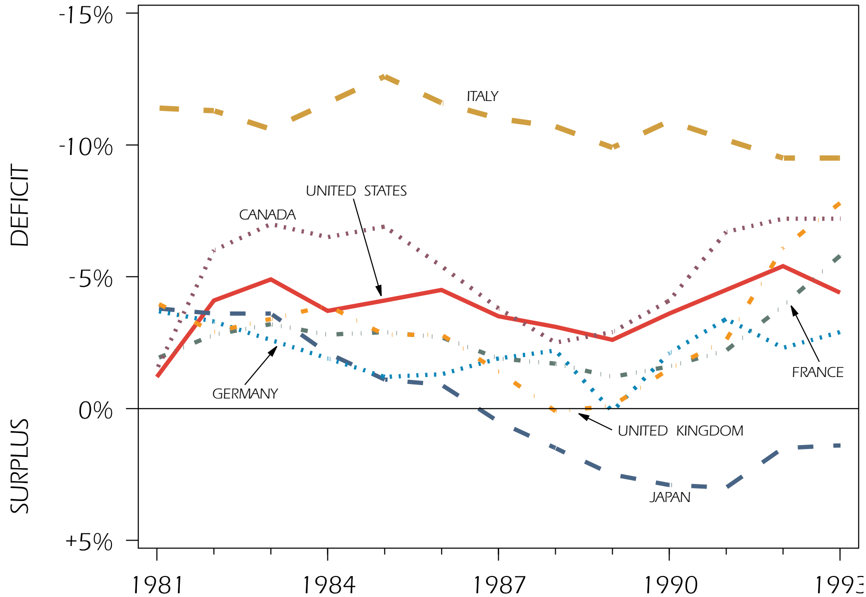
The short answer is, yes. The deficit forces the Government to borrow money in the private capital markets. That borrowing competes with (1) borrowing by businesses that want to build factories and machines that make workers more productive and raise incomes, and (2) borrowing by families who hope to buy new homes, cars, and other goods. The competition for funds tends to produce higher interest rates.

Deficits increase the Federal debt and, with it, the Government's obligation to pay interest. The more it must pay in interest, the less it has available to spend on education, law enforcement, and other important services, or the more it must collect in taxes—forever after. Today, the Government spends 15 percent of its budget to pay interest.

As shown in Chart 4–4, the Federal interest burden grew substantially in the 1980s. By 1997, net interest spending will be nearly as much as the Government will spend on national defense.

In the end, the deficit is a decision about our future. We can provide a solid foundation for future generations, just as parents try to do within a family by

Chart 4–3. Total Government Surplus or Deficit as a Percent of GDP



Source: OECD, calendar year data.

Relative to the above economies, the total Government budget deficit in the United States is average.

limiting the amount of debt that they pass on; or we can generate large deficits and debt for those who come after us.

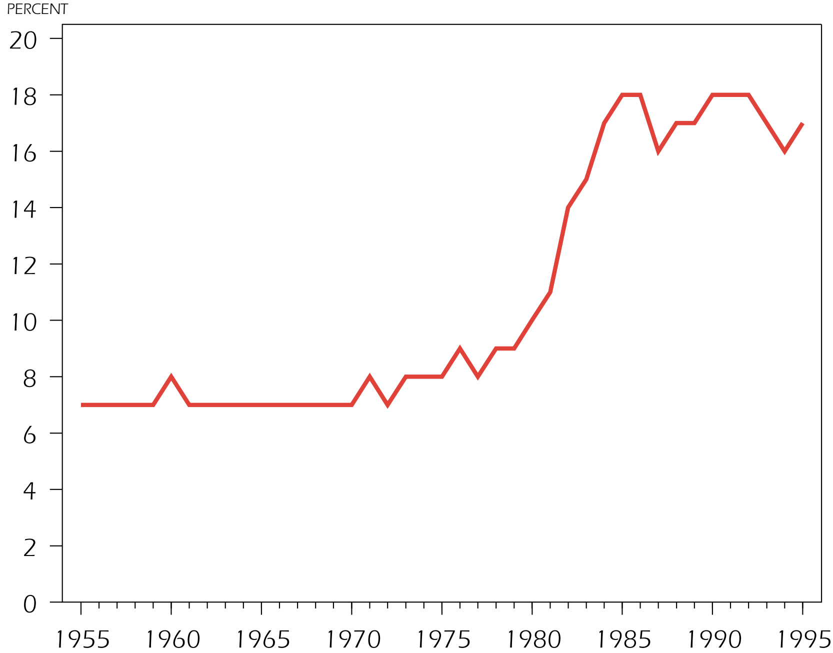
Deficits and Debt

If the Government incurs a deficit, it must borrow from the public.

Table 4–1 summarizes the relationship between the budget deficit and Federal borrowing.

Federal borrowing involves the sale, to the public, of notes and bonds of varying sizes and time periods. The cumulative amount of borrowing from the public—i.e., the debt held by the public—is the most important measure of Federal debt because it is what the Government has borrowed in the private markets over the years, and it determines how much the Government pays in interest to the public.

Chart 4–4. Interest Costs as a Percent of Income Tax Revenues Over 40 Years



Debt held by the public was $3.6 trillion at the end of 1995—roughly the net effect of deficits and surpluses over the last 200 years. Debt held by the

Table 4–1. Federal Government Financing and Debt

(In billions of dollars)

	1995 Actual	Estimate 1996	1997	1998	1999	2000	2001	2002
Federal Government financing:								
Budget deficit (–) or surplus	-164	–146	–140	–98	–64	–28	8	44
Other means of financing.......	–7	–20	–24	–27	–29	–29	–28	–27
Borrowing from the public	171	165	164	124	93	57	20	–17
Federal Government debt:								
Debt held by the public	3,603	3,769	3,933	4,057	4,151	4,207	4,227	4,210
Debt held by government accounts	1,318	1,439	1,566	1,693	1,828	1,978	2,133	2,297
Gross Federal debt...............	4,921	5,207	5,499	5,750	5,979	6,185	6,360	6,506
Debt subject to legal limit	4,885	5,163	5,456	5,711	5,939	6,145	6,321	6,468

Note: Numbers may not add to the totals due to rounding.

public does not include debt the Government owes itself—the total of all trust fund surpluses and deficits over the years, like the Social Security surpluses, that the law says must be invested in Federal securities.

The sum of debt held by the public and debt the Government owes itself is called Gross Federal Debt. At the end of 1995, it totaled $4.9 trillion.

Another measure of Federal debt is debt subject to legal limit, which is similar to Gross Federal Debt. When the Government reaches the limit, it loses its authority to borrow more to finance its spending; then, the President and Congress must enact a law to increase the limit.

The Government's ability to finance its debt is tied to the size and strength of the economy, or GDP. Debt held by the public exceeded 50 percent of GDP at the end of 1996. As a share of GDP, debt held by the public was highest at the end of World War II, at 114 percent, then fell to 24 percent in 1974 before gradually rising to current levels.

That decline, from 114 to 24 percent, occurred because the economy grew faster than the debt accumulated; debt held by the public rose from $242 billion to $344 billion in those years, but the economy grew faster.

Individuals and institutions in the United States hold over 75 percent of debt held by the public. The rest is held in foreign countries.

Deficit Reduction Efforts

Ever since the deficit soared in the early 1980s, successive Presidents and Congresses have tried to cut it. Until recently, they met with only limited success.

In the early 1980s, President Reagan and Congress agreed on a large tax cut, but could not agree about cutting spending; the President wanted to cut domestic spending more than Congress, while Congress sought fewer defense funds than the President wanted. They wound up spending more on domestic programs than the President wanted, and more on defense than Congress wanted. At the same time, a recession led to more spending to aid those affected by the recession, and reductions in tax revenues due to lower incomes and corporate profits.

By 1985, both sides were ready for drastic measures. That year, they enacted the Balanced Budget and Emergency Deficit Control Act, better known as Gramm-Rudman-Hollings (GRH). It set annual deficit targets for five years, declining to a balanced budget in 1991. If necessary, GRH required across-the-board cuts in programs to comply with the deficit targets.

Faced with the prospect of huge spending cuts in 1987, however, the President and Congress amended the law, postponing a balanced budget until 1993. The President and Congress never achieved those revised targets, in part because of the extraordinary costs of returning the Nation's savings and loan industry to a sound financial footing.

By 1990, President Bush and Congress enacted spending cuts and tax increases that were designed to cut the accumulated deficits by about $500 billion over five years. They also enacted the Budget Enforcement Act (BEA)—rather than set annual deficit targets, the BEA was designed to limit discretionary spending while ensuring that any new entitlement programs or tax cuts did not make the deficit worse.

First, the BEA set annual limits on total discretionary spending for defense, international affairs, and domestic programs. Second, it created "pay-as-you-go" rules for entitlements and taxes: those who proposed new spending on entitlements or lower taxes were forced to offset the costs by cutting other entitlements or raising other taxes.

For what it was designed to do, the law worked. It did, in fact, limit discretionary spending and force proponents of new entitlements and tax cuts to find ways to finance them. But the deficit, which Government and private experts said would fall, actually rose.

Why? Because the recession of the early 1990s reduced individual and corporate tax revenues and increased spending that is tied to economic fluctuations. Federal health care spending also continued to grow rapidly.

In 1993, President Clinton and the Congress made another effort to cut the deficit. They enacted a five-year deficit reduction package of spending cuts and higher revenues. The law was designed to cut the accumulated deficits from 1994 to 1998 by about $500 billion. The new law extended the limits on discretionary spending and the "pay-as-you-go" rules.

Clearly, the President's deficit reduction efforts have paid off. The deficit fell from $290 billion in 1992 to $164 billion in 1995, and by over half as a share of GDP, to 2.3 percent. Now, as you will see in the next chapter, the President wants to finish the job by balancing the budget over the next seven years.