Deficit Disorder:

Sense and Nonsense about the Federal Debt

Reality Check

Many politicians claim to be focused on jobs, jobs, jobs, but as the U.S. economy continues to struggle, meaningful governmental action to boost employment remains thwarted by a more pervasive obsession in Washington: deficits, deficits, deficits. Unemployment levels are expected to remain above 8 percent over the next two years, but proposals to invest significant resources in new job-creation activities have made little progress, mainly due to congressional concerns over deficits. To assuage those worries, President Barack Obama created a bipartisan commission—the National Commission on Fiscal Responsibility and Reform—to make recommendations for reducing the long-term federal debt and proposed a freeze on federal "discretionary" spending outside of defense and homeland security. In the tug-of-war between proponents of public investment to strengthen the economy and deficit hawks, those preoccupied with budget shortfalls are having little difficulty pulling the rope in their direction.

Federal balance sheets can be complex and less than scintillating to average citizens. As a consequence, media coverage of deficits tends to be dominated by alarmism. It is much easier to capture the attention of viewers and readers by scaring them with tales of leaving our children with a bankrupt government under the control of China than to walk them through the potential trade-offs connected to different scenarios.

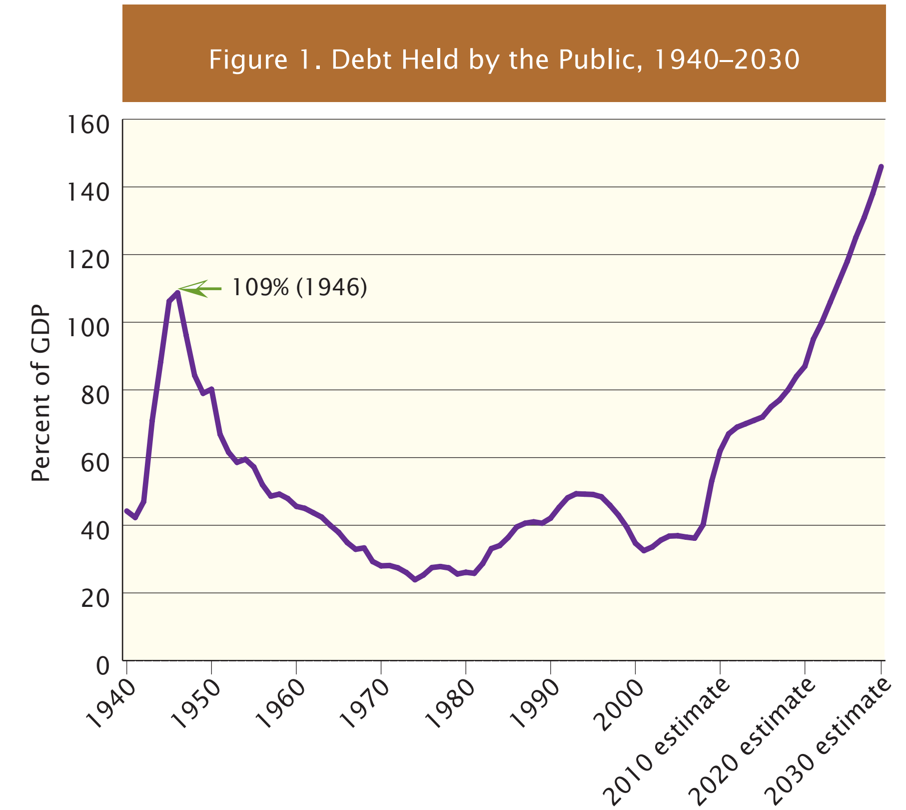
This Century Foundation Reality Check focuses on correcting commonly repeated but misleading claims related to federal deficits, aided by straightforward figures and tables that anyone can understand.

Deficit Distortion #1: "Fiscal conditions have never been worse."

The Great Recession, from which the United States appears to be slowly emerging, punished the federal government's balance sheet just as surely as it did the economy and the budgets of average households. As jobs disappeared and incomes fell, so too did federal tax revenue. At the same time, federal spending increased, as more Americans became eligible for programs such as Medicaid, food stamps, and other supports. Federal economic stimulus helped to stabilize the economy and stop job losses, but it also increased outlays. Those effects substantially widened deficits that were already rapidly growing due to policies implemented under President George W. Bush, including two sets of huge tax cuts that primarily benefited wealthy families, coupled with escalated spending on defense, homeland security, and the new, unfunded Medicare prescription drug benefit. The one-two punch of Bush administration deficit-creating policies followed by the economic collapse left the government facing shortfalls of around 9 percent to 10 percent of gross domestic product (GDP), the largest deficits since the end of World War II.[1]

The accumulation of annual budget deficits requires the U.S. Treasury to issue securities to cover the shortfalls; the total amount of those outstanding securities comprises the federal debt. The Congressional Budget Office reported that, at the end of 2009, U.S. debt held by the public amounted to about 53 percent of GDP. This figure excludes intragovernmental obligations. That level is projected to jump to 62 percent of GDP next year, rising to an estimated 87 percent by 2020. As Figure 1 shows, even 87 percent of GDP is substantially below the level reached toward the end of World War II of over 109 percent of GDP. In 1950, the amount of publicly held debt was still above 70 percent of GDP, but on a path to descend steadily as the economy boomed and tax revenues rose. It is the period beyond 2020 when forecasts show debt spiraling ever upward toward a path that ultimately would exceed the World War II levels.

Figure 1. Debt Held by the Public, 1940–2030

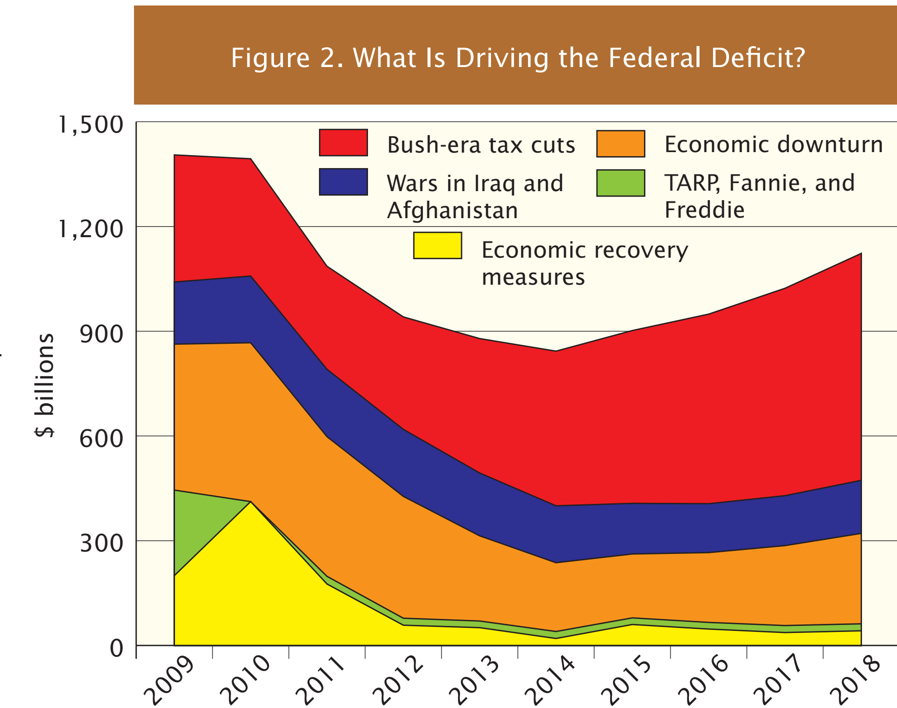


Source: Budget of the United States Government Fiscal Year 2011, Historical Tables, Table 7.1 (Washington, D.C.: Office of Management and Budget), http://www.whitehouse.gov/omb/budget/Historicals/ and *The Budget and Economic Outlook: Fiscal Years 2010 to 2020*, Table 1-1 (Washington, D.C.: Congressional Budget Office, 2010), http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf.

Deficit Distortion #2: "Federal stimulus policies are mainly responsible for exploding the deficit."

In 2001, when President George W. Bush took office, the federal budget was in surplus by $281 billion (2.8 percent of GDP). At the time, the Congressional Budget Office (CBO) projected that surpluses would rise to $710 billion or 5.1 percent of GDP by 2009. A combination of large tax cuts, spending increases on defense and homeland security, and the enactment of the unfunded Medicare D drug benefit caused those large and growing surpluses to transform into large and growing deficits. Although the economic downturn and the policies enacted at the end of the Bush administration and under President Obama to respond to the crisis exacerbated deficits, the 2009 shortfall still can be attributed largely to Bush-era policies, according to Economic Policy Institute analysis. By 2009, deterioration from the CBO baseline projection totaled $2.38 trillion. Rather than a surplus equal to 5 percent of GDP, the U.S. deficit was estimated at $1.67 trillion (12 percent of GDP) in 2009. Economic decline and other revised technical assumptions made by CBO account for less than half of the change, 42.3 percent. The stimulus enacted under President Obama accounts for just 7.6 percent. Other policy changes enacted prior to 2009 that affected spending and revenue make up 42.4 percent of the change.[2]

While many still want to pin the blame for growing deficits on recent economic stimulus measures and federal bailouts such as the Troubled Asset Relief Program (TARP)—the federal effort that shored up the banking industry during the recent mortgage crisis—those policy choices have little to do with the long-term projections of budget deficits. The biggest challenges in confronting high budget deficits is how to cope with the loss of federal revenue due to tax cuts, the cost of waging wars, and the economic downturn (see Figure 2).

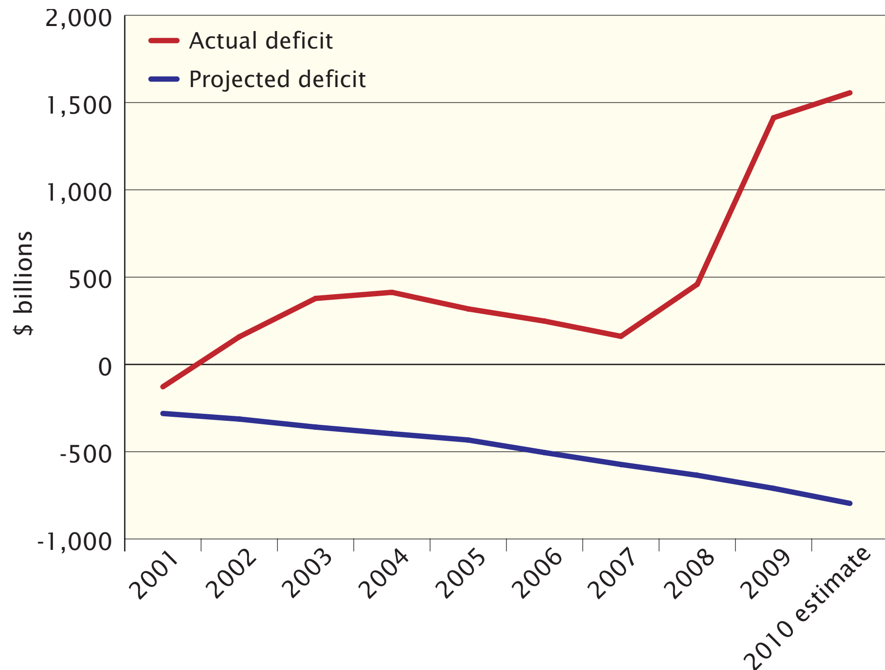


Note: Fannie and Freddie refer to U.S. government cost for conservatorship of Fannie Mae and Freddie Mac, which began in 2008.

Source: Kathy A. Ruffing and James R. Horney, "Critics Still Wrong on What's Driving Deficits in Coming Years," Center on Budget and Policy Priorities, June 28, 2010, Table 1, http://www.cbpp.org/files/12-16-09bud.pdf.

Deficit Distortion #3: "Government budget forecasts are highly reliable."

Figure 3. Projected versus Actual Budget Surplus/Deficit, 2001-2010



Note: Positive numbers indicate an increase in the deficit.

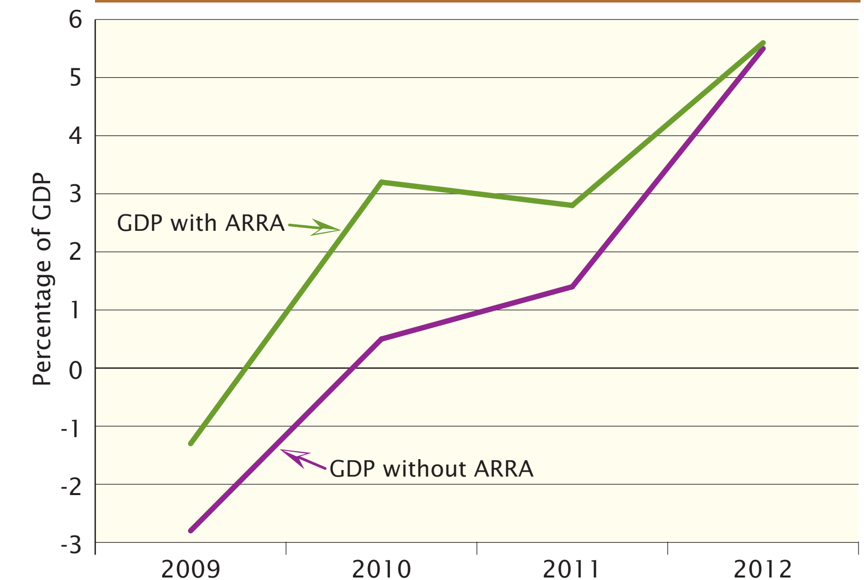
Source: The Budget and Economic Outlook: Fiscal Years 2002 to 2011, Table 1-1 (Washington, D.C.: Congressional Budget Office, 2001), http://www.cbo.gov/ftpdocs/27xx/doc2727/entire-report.pdf and *Budget of the United States Government Fiscal Year 2011, Historical Tables*, Table 1.1 (Washington, D.C.: Office of Management and Budget), http://www.whitehouse.gov/omb/budget/Historicals/.

Past budget forecasts consistently have proven to be way off target. They often quickly become outdated for a variety of reasons: a changing economic environment, newly enacted policies, unanticipated expenses such as fighting wars in Iraq and Afghanistan, or even unexpected developments such as the collapse of the Soviet Union that, for a time, allowed for a peace dividend. Figure 3 shows the 2000 Congressional Budget Office projections for rising surpluses in contrast to the actual deficits that occurred. Instead of a cumulative surplus forecasted to be $5 trillion dollars over the period of 2001 to 2010, the federal government actually ran a cumulative *deficit* of $4.9 trillion—a swing of about $10 trillion dollars. Other past forecasts have been excessively pessimistic. Budget forecasts ought to inform policymaking, but they are only one part of the puzzle. Given how uncertain they are and how unreliable they have proven to be in the past, they should not overwhelm other important considerations. It would be counterproductive to make significant cuts in an essential program based only on projections that might significantly improve with modestly better than expected economic conditions or less radical policy adjustments.

Deficit Distortion #4: "Government spending did not help end the Great Recession."

In each quarter, from the second of 2009 through the first of 2010, the Council of Economic Advisors estimated that the stimulus legislation enacted last year boosted the annual level of GDP by 0.7 percent to 2.9 percent. Despite the weaker than anticipated economy, the Congressional Budget Office estimated that the American Recovery and Reinvestment Act (ARRA) still managed to add an estimated 1.0 million to 2.1 million jobs between October and December of 2009.

Figure 4. Impact of ARRA on GDP



Source: Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from October 2009 through December 2009 (Washington, D.C.: Congressional Budget Office, 2010), http://www.cbo.gov/ftpdocs/110xx/doc11044/02-23-ARRA.pdf.

Recent estimates from private firms such as Moody's Economy.com and IHS Global Insight indicate that, through 2010, ARRA will improve GDP by two percentage points over non-ARRA projections; these firms also estimate that ARRA will reduce unemployment by up to two percentage points. Agreement across a wide range of analysts, both public and private, counters the negative and erroneous misconceptions about ARRA's impact. (See Figure 4, Tables 1 and 2.)

Table 1. Estimates of the Effects of the ARRA on the Level of GDP (percent change)

	2009 Q2	2009 Q3	2009 Q4	2010 Q1
CEA: Projection approach	+0.7	+1.4	+2.5	+2.9
CEA: Model approach	+0.7	+1.7	+2.1	+2.5
CBO: Low	+0.9	+1.3	+1.5	+1.5
CBO: High	+1.5	+2.7	+3.5	+3.9
Goldman Sachs	+0.5	+1.4	+1.9	+2.3
IHS/Global Insight	+0.5	+1.2	+1.7	+2.0
JPMorganChase	+1.2	+1.8	+2.6	+3.3
James Glassman, Macroeconomic advisers	+0.5	+1.0	+1.4	+1.7
Mark Zandt, Moody's Economy.com	+0.8	+1.6	+2.2	+2.5

Source: Recovery Act Third Quarterly Report—Evidence of Economic Impact: Evidence of the Economic Impact of the Recovery Act (Washington, D.C.: Council of Economic Advisors, 2010), http://www.whitehouse.gov/administration/eop/cea/factsheets-reports/economic-impact-arra-3rd-quarterly-report/section-3.

Table 2. Estimates of the Effects of the ARRA on the Level of Employment

	2009 Q2	2009 Q3	2009 Q4	2010 Q1
CEA: Projection approach	+334,000[a]	+1,060,000[b]	+1,945,000[c]	+2,825,000[d]
CEA: Model approach	+380,000	+1,095,000	+1,742,000	+2,230,000
CBO: Low	+300,000	+700,000	+1,000,000	+1,200,000
CBO: High	+500,000	+1,300,000	+2,100,000	+2,700,000
IHS/Global Insight	+228,000	+686,000	+1,248,000	+1,707,000
Macroeconomic advisers	+248,000	+623,000	+1,057,000	+1,462,000
Mark Zandt, Moody's Economy.com	+500,000	+1,008,000	+1,486,000	+1,896,000

[a] Datapoint reflects and estimate for May.
[b] Datapoint reflects and estimate for August.
[c] Datapoint reflects and estimate for November.
[d] Datapoint reflects and estimate for February.

Source: Recovery Act Third Quarterly Report - Evidence of Economic Impact: Evidence of the Economic Impact of the Recovery Act (Washington, D.C.: Council of Economic Advisors, 2010), http://www.white-house.gov/administration/eop/cea/factsheets-reports/economic-impact-arra-3rd-quarterly-report/section-3.

Deficit Distortion #5: "The public believes deficit reduction is the most important priority facing the country."

While public opinion polls show that Americans feel that deficit reduction is important, they indicate even greater concern about other issues, such as the economy, health care, and unemployment. Polling conducted by the Pew Research Center for the People and the Press, summarized in Table 3, tracks the frequency that particular issues are named as top domestic priorities over the past ten years. In the past year, public concern over deficits increased, but over time, six other issues are named more frequently as top priorities. Not incidentally, advancing those goals generally would require increased federal spending, which would increase deficits.

Table 3. Top Domestic Priorities for Obama and Congress

Percent considering each as a "top priority"	Jan. 2001	Jan. 2002	Jan. 2003	Jan. 2004	Jan. 2005	Jan. 2006	Jan. 2007	Jan. 2008	Jan. 2009	Jan. 2010	2009-10 change
Strengthening nation's economy	81	71	73	79	75	66	68	75	85	83	-2
Improving the job situation	60	67	62	67	68	65	57	61	82	81	-1
Defending U.S. against terrorism	–	83	81	78	75	80	80	74	76	80	+4
Securing Social Security	74	62	59	65	70	64	64	64	63	66	+3
Improving educational system	78	66	62	71	70	67	69	66	61	65	+4
Securing Medicare	71	55	56	62	67	62	63	60	60	63	+3
Reducing budget deficit	–	35	40	51	56	55	53	58	53	60	+7
Reducing health care costs	–	–	–	–	–	–	68	69	59	57	-2
Dealing with problems of poor	63	44	48	50	59	55	55	51	50	53	+3
Strengthening the military	48	52	48	48	52	42	46	42	44	49	+5
Dealing with US energy problem	–	42	40	46	47	58	57	59	60	49	-11
Providing health ins. to uninsured	61	43	45	54	60	59	56	54	52	49	-3
Reducing crime	76	53	47	53	53	62	62	54	46	49	+3
Dealing with moral breakdown	51	45	39	45	41	47	47	43	45	45	0
Stricter rules for financial institutions	–	–	–	–	–	–	–	–	–	45	–
Protecting the environment	63	44	39	49	49	57	57	56	41	44	+3
Reducing middle-class taxes	66	43	–	44	48	51	48	46	43	42	-1
Dealing with illegal immigration	–	–	–	–	–	–	55	51	41	40	-1
Reducing influence of lobbyists	–	–	–	–	–	–	35	39	36	36	0
Dealing with global trade	37	25	–	32	32	30	34	37	31	32	+1
Dealing with global warming	–	–	–	–	–	–	38	35	30	28	-2

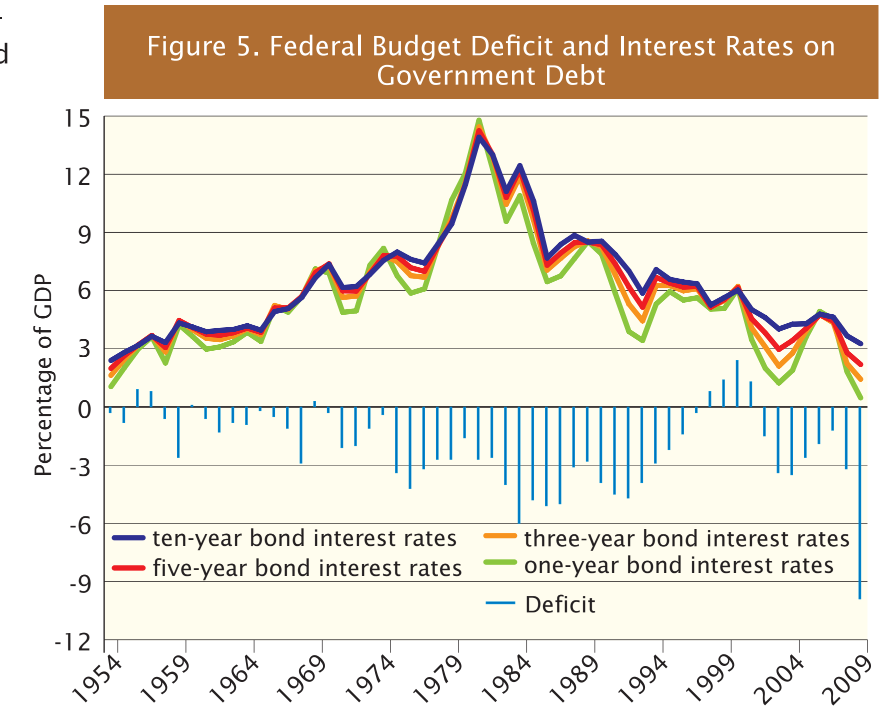
Source: Public's Priorities for 2010: Economy, Jobs, Terrorism (Washington, D.C.: The Pew Research Center for the People and the Press, 2010), http://people-press.org/report/584/policy-priorities-2010.

Deficit Distortion #6: "Government borrowing dampens the economy by raising interest rates."

Since interest rates represent the price of borrowing money, traditional economic theory holds that the rise and fall of interest rates are a reflection of supply and demand. If the government borrows money, it does so by issuing Treasury bonds. The market should respond to this increased supply of bonds by driving down their price. Historically, it has been accepted that there is an inverse relationship between the price of a bond and interest rates; if bond prices drop, then the result should be higher interest rates. However, this has not happened over the past ten years; instead, as *New York Times* economics columnist Paul Krugman recently wrote, "On reflection, it's obvious why: a weak economy both drives up deficits and drives down the demand for funds, while a strong economy does the reverse."[3] When the economy is doing poorly, private firms are less likely to borrow for purposes of private investment, even if interest rates are low. For example, those conditions have prevailed in Japan for many years now.

Looking back at interest rates and federal budget deficits from 1954 onward (see Figure 5), large increases in deficits actually are associated with declines in interest rates. In general, large increases in deficits occur during recessions, which coincide with declines in demand for loanable funds. Federal Reserve policy also becomes more accommodating during recessions, putting further downward pressure on interest rates. It is only when the economy regains full strength, with minimal excess capacity, when high deficits can put upward pressure on interest rates. The U.S. economy still has far too much unemployment and unused capital resources to begin worrying about rising rates.

Figure 5. Federal Budget Deficit and Interest Rates on Government Debt



Note: Positive numbers indicate an increase in the surplus.
Source: Federal Reserve data synthesized in Josh Bivans, "Budget Deficit and Interest Rates: Storm on the Horizon or all Clear?" Figure E, Economic Policy Institute, Issue Brief 262, April 26, 2010.

Deficit Distortion #7: "Cutting Social Security benefits has to be part of the long-term solution."

Social Security provides essential retirement, disability, and family life insurance protections for all Americans, and according to the program's trustees, will be able to continue to pay promised benefits in full until 2037, after which payroll taxes would be able cover three-quarters of promised benefits.[4] Over the next seventy-five years, Social Security's long-term shortfall amounts to about 0.7 percent of GDP. Social Security is responsible for significant reductions in poverty levels among the elderly. The average retirement benefit is about $14,000 a year, and because the majority of retirees depend on Social Security for more than half their income, cutting benefits could have serious negative consequences for future beneficiaries.

The main cause of increasingly bleak forecasts of long-term deficits is the expectation that health care costs will continue to rise much more rapidly than inflation. As Figure 6 shows, Social Security's costs are expected to increase at a much slower rate than Medicare and Medicaid, which are the main drivers of escalating deficits. The recently enacted health care legislation includes many changes intended to curtail those cost increases, although uncertainty about their effectiveness resulted in relatively small reductions in the government's projections for future deficits.

In any case, addressing the deficit challenge does not require Social Security benefit cuts. Closing the gap between promised Social Security payments and available revenues could be accomplished simply by eliminating the cap on income subject to payroll taxes (currently $106,800). Other modest changes could also sustain the program indefinitely.

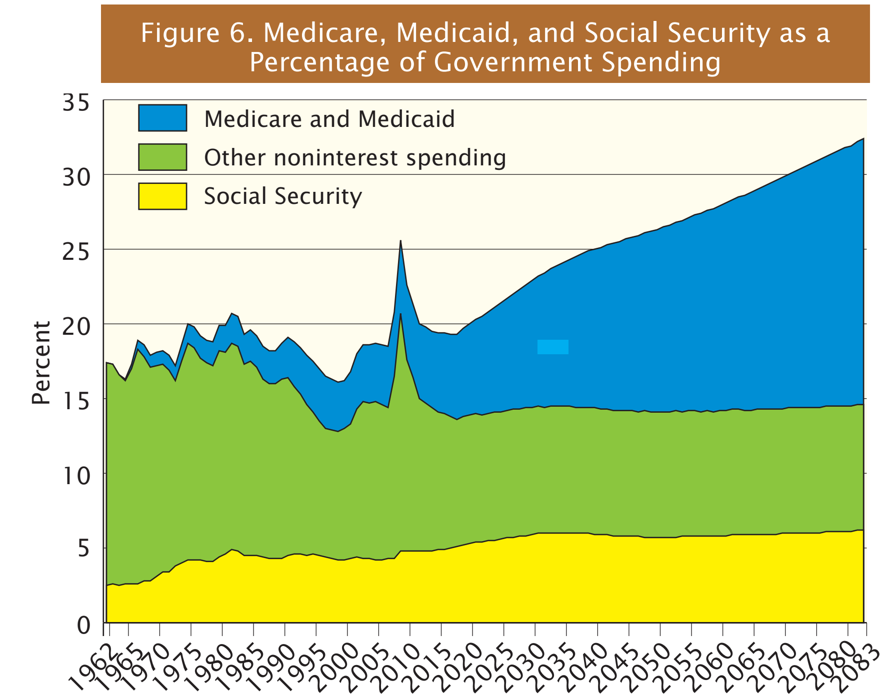


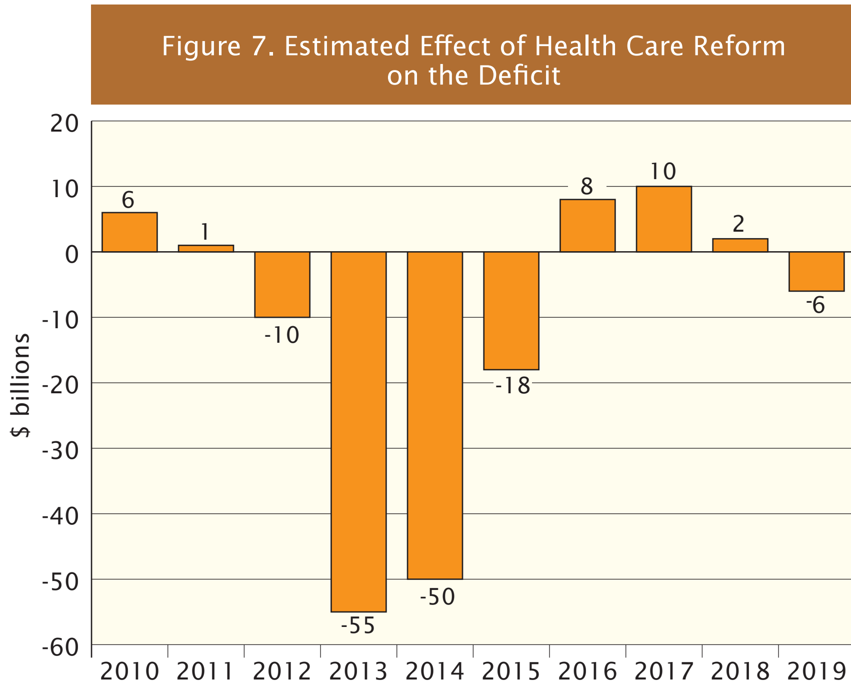
Figure 6. Medicare, Medicaid, and Social Security as a Percentage of Government Spending

Source: Congressional Budget Office, *The Long-Term Budget Outlook* 2009 (Washington, D.C.: Government Printing Office, 2009), Figure 1-1.

Deficit Distortion #8: "Health care reform only will make deficits worse."

While those who opposed the health care bill argued that it would add to deficits, the legislation was designed to pay fully for added costs. Those changes included increased Medicare payroll taxes on upper-income workers and eliminating the inefficient Medicare Advantage plan that provided wasteful subsidies to private insurers. Figure 7 shows the projected impact on the federal budget of the health care legislation. After two years of adding to the deficit, the ten-year projection shows a net reduction (on-budget savings) of $114 billion due to the reform. In its letter to Congress, the CBO stated, "Reflecting the changes made by the reconciliation proposal, the combined effect of enacting H.R. 3590 and the reconciliation proposal would also be to reduce federal budget deficits over the ensuing decade relative to those projected under current law—with a total effect during that decade in a broad range around one-half percent of GDP."[5]

Figure 7. Estimated Effect of Health Care Reform on the Deficit



Notes: Positive numbers indicate an increase in the deficit. Components might not equal the total due to rounding.

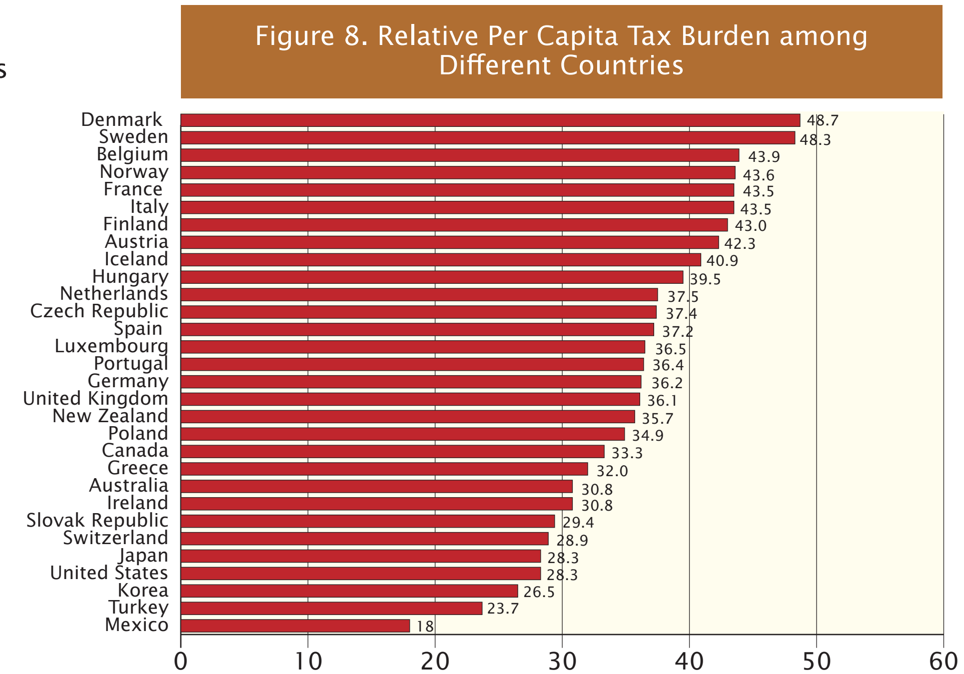
Source: Letter to Speaker Nancy Pelosi Regarding HR 3590 and HR 4872 (Washington, D.C.: Congressional Budget Office, March 20, 2010), http://www.cbo.gov/ftpdocs/113xx/doc11379/AmendReconProp.pdf.

Deficit Distortion #9: "U.S. Taxes Cannot Be Raised Any Further without Damaging the Economy."

Figure 8 shows the relative per capita tax burden among different countries (taking into account state and local as well as federal taxes). More than two-thirds of other developed nations have higher tax levels than the United States.

When federal taxes were increased in the United States in 1993 under President Bill Clinton, the economy defied the predictions of those opposed to the hikes and proceeded to grow robustly until the end of the decade. Growth was so strong, in fact, that deficits transformed into surpluses, as rising incomes generated higher revenues. (See Figure 9, page 18.)

Figure 8. Relative Per Capita Tax Burden among Different Countries



Source: Tax Revenue Statistics, Organisation for Economic Co-operation and Development, 2009, http://www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#trs.

By increasing revenues in ways that also make America's highly complex, loophole-ridden income tax code more efficient and fair, reform could improve prospects for economic growth and broadly shared prosperity.

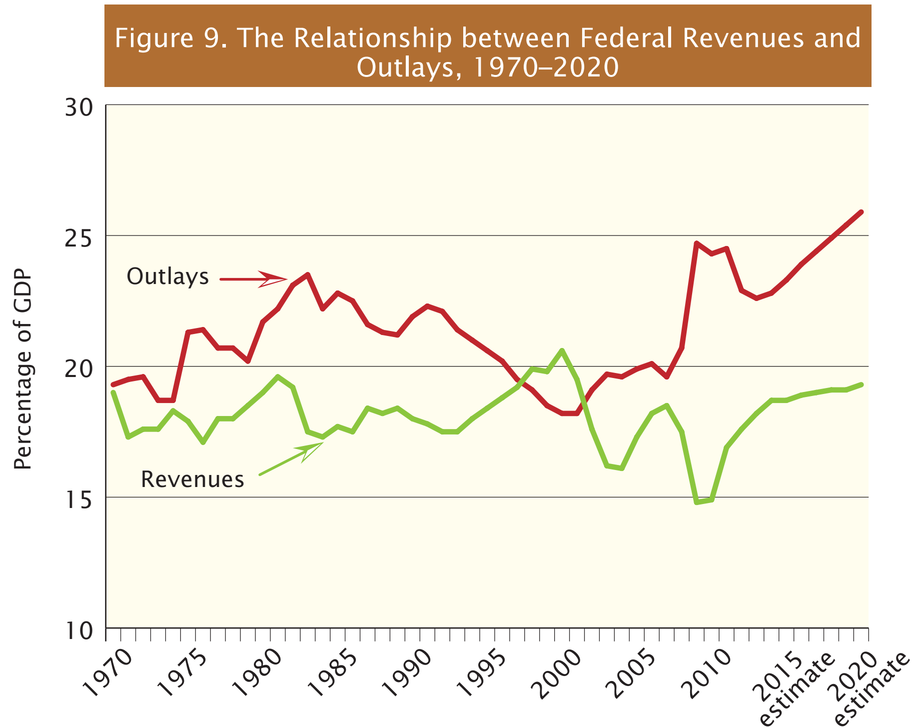


Figure 9. The Relationship between Federal Revenues and Outlays, 1970–2020

Source: Budget of the United States Government Fiscal Year 2011, Historical Tables, Table 1.2 (Washington, D.C.: Office of Management and Budget), http://www.whitehouse.gov/omb/budget/Historicals/, and The Long-Term Budget Outlook, Additional Information Table (Washington, D.C.: Congressional Budget Office, June 2010), http://www.cbo.gov/doc.cfm?index=11579.

Conclusion

The prospect of federal debt spiraling out of control in the 2020s and beyond is cause for serious concern. But addressing the more immediate problems of high joblessness, income stagnation, and slow growth through additional public investment could help to improve the long-term fiscal outlook by helping to get the United States back on a path toward broadly shared prosperity. Cutting social insurance programs is unnecessary and would only heighten the vulnerability of American families who are already experiencing increasing levels of economic insecurity.

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1 *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (Washington, D.C.: Congressional Budget Office, 2010), 3, http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf.

2 John Irons, Kathryn Edward, and Anna Turner, "The 2009 Budget Deficit: How Did We Get Here?" Economic Policy Institute, Issue Brief 262, August 20, 2009, http://epi.3cdn.net/0974dad8645a9d3216_5tm6bnxqd.pdf.

3 Paul Krugman, "Deficits and Interest Rates," Blog post, August 14, 2009, http://krugman.blogs.nytimes.com/2009/08/14/deficits-and-interest-rates/.

4 A Summary of the 2009 Annual Reports, Social Security and Medicare Boards of Trustees Social Security Administration, May 2009, http://www.ssa.gov/OACT/TRSUM/index.html.

5 Douglas W. Elmendorf, Director, Congressional Budget Office, Letter to Speaker Nancy Pelosi Regarding HR 3590 and HR 4872 March 20, 2010, 12, http://www.cbo.gov/ftpdocs/113xx/doc11379/AmendReconProp.pdf.

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