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The U.S. Deficit Outlook

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"Last year's deficit was the largest as a share of GDP since the end of World War II, and the deficit expected for 2010 would be the second largest."

—Douglas Elmendorf (Director, Congressional Budget Office), Director's Blog, January 26, 2010

The U.S. government undertook unprecedented fiscal stimulus actions in 2009 in response to the deep, protracted recession and the fallout from the worst financial crisis in decades. As a result, in fiscal year (FY) 2009 the deficit totaled a little more than $1.4 trillion (or $4,605.76 per U.S. resident), more than triple the FY 2008 deficit and nearly nine times the FY 2007 deficit. Economists usually measure the deficit as a share of gross domestic product (GDP), which can be thought of as the nation's total income produced in a year. The deficit news is equally bleak by this measure as well. Over this two-year period, the deficit increased from 1.2 percent of GDP to nearly 10 percent of GDP, a level not seen since World War II. These enormous budget deficits have resulted in a resurgence of the age-old debate in policy discussions about the budget deficit's effect on the economy.

The federal budget deficit is estimated each month and consists of the surplus of government spending over government revenue. In its recent medium-term outlook for the budget and the economy, the Congressional Budget Office projects that the budget deficit will equal 9.2 percent of GDP in FY 2010, but then steadily decline (both in absolute value terms and as a share of GDP) every year thereafter until 2016. Persistently large budget deficits have many economists worried about their effects on the long-term health of the economy.

When the government increases its spending relative to its revenues but does not increase taxes to pay for the increased spending, it must borrow from the private sector. This borrowing takes the form of new bonds issued by the Treasury. When this occurs, the government must compete with other private-sector borrowers, which tends to put upward pressure on interest rates and, in turn, can result in a reduction in spending and investment. Economists often are wary of deficit spending because of these potential consequences.

As large deficits are added to the total national debt, a ballooning national debt may cause international markets to worry about buying our debt as the risk of default increases. In turn, this default risk may cause investors to demand higher interest rates, which increases the Treasury's cost of financing the debt. In 2009, interest payments on the U.S. debt totaled $187 billion—1.3 percent of GDP—and the Congressional Budget Office estimates that in 2020 interest payments will increase to $723 billion, almost four times the 2009 figure, and reach 3.2 percent of GDP.

Some ongoing strains on the U.S. deficit are programs such as Medicare, Medicaid, and Social Security. According to the Office of Management and Budget, Medicare and Social Security expenditures represented 27.7 percent of expenses in 1990. In 2009, they grew to 31.7 percent, and the Office of Management and Budget projects the percentage to increase to 35.5 by 2015. One question facing policymakers today is how to support these programs in a more sustainable way.

Some economists argue that temporarily increasing spending (on such things as infrastructure, job training, and extended unemployment benefits during economic slowdowns (as the government is doing during the current recession) may be one favorable policy tool to moderate swings in the business cycle in the short term by boosting output and employment. They argue that the funds can accelerate recovery and could lead to higher national income in the future, thereby resulting in later deficit reductions.

Budget deficits have climbed in recent years, but compared with other countries the debt of the U.S. government is not exceptionally large. In 2009, estimated publicly held debt outstanding totaled 53 percent of GDP. In 2009, France had publicly held debt totaling 80 percent of GDP, while Italy and Japan had ratios equaling 115 and 192 percent, respectively. With all these factors to consider, undoubtedly, the deficit debate will continue.

—By Hoda El-Ghazaly, Research Associate

Recent Articles and Further Reading on Budget Deficits

"Deficits, Debt and Looming Disaster: Reform of Entitlement Programs May Be the Only Hope," by Michael Pakko, Federal Reserve Bank of St. Louis *Regional Economist*, January 2009, pp. 4-9.

This article looks at the effects of large deficits and debt and discusses the need for change in programs such as Social Security and Medicare.

"Deficits May Alter U.S. Politics and Global Power," by David E. Sanger, *New York Times*, February 1, 2010.

This article discusses the possible effects of deficits on the ability of the United States to maintain political power.

"The Budget and Economic Outlook: Fiscal Years 2010 to 2020," Congressional Budget Office, January 2010.

The report gives projections for the deficit and debt for the current decade.

Free Data Sources and Reports

Data: Summary tables of the U.S. budget
Description: Historical tables of the U.S. budget from 1940 or earlier; also includes projections of the budget until 2011 or 2015
Published by: Office of Management and Budget
Location: http://www.whitehouse.gov/omb/budget/Historicals/

Data: Data on the debt/deficits of the U.S. government
Description: Quarterly and annual data series on the debt of the federal government
Published by: Federal Reserve Bank of St. Louis
Location: http://research.stlouisfed.org/fred2/categories/5

Data: Real-time U.S. National Debt Clock
Description: The gross public national debt (to the penny and continuously updated) and who holds it
Published by: USdebtclock.org
Location: http://www.usdebtclock.org/

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