Center for American Progress

Deficits and Debt 101

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What is a budget deficit?

The federal government collects taxes, fees, and other revenues each year while spending on programs and operations. A deficit occurs when total expenditures in a given fiscal year exceed total revenues. When this happens, the government has to borrow money to make up the difference.

A surplus occurs when the government takes in more money than it spends. The federal budget has been in surplus only 13 years since 1930. But in many years the deficit has been very small.

How big is the current budget deficit?

In 2009 the federal government is expected to spend about $1.6 trillion more than it collects in revenue. In dollar terms this is the largest deficit in American history. However, when comparing the size of deficits across years the basic dollar amount is misleading. After all, one dollar in 1930 is not the same as one dollar in 2009.

A better way to measure the size of a deficit is by comparing it to the total size of the economy. For example, in 2009, total economic output—known as the gross domestic product, or GDP—is estimated to be worth about $14.1 trillion, and the deficit would be about 11.2 percent of that. By this measure the current deficit is large, but not the largest ever. In 1943 the deficit amounted to 30.3 percent of total economic output, which in today's economy would be about $4.3 trillion.

This year's deficit is a product of extraordinary circumstances. The combination of the severe recession, efforts to revive the economy, and an existing budget gap produced this year's eye-catching numbers. But these specific circumstances are likely to fade, and as they do, the deficit will shrink.

What is the difference between deficit and debt?

When the government spends more than it collects in revenue and runs a deficit, it needs to make up the difference through borrowing. The sum of all that borrowing is the national debt (although there are some complicating factors, such as "off-budget expenditures" and how certain kinds of spending are counted for deficits). In other words, the deficit is the yearly shortfall, and the debt is the total amount that the government owes to its creditors from whom it borrowed to make up those shortfalls.

Where does the government get the money to fill in deficits?

In general, the federal government borrows money from two sources: the public and itself. The government borrows money from the public mainly by issuing treasury bills, notes, and bonds, which are collectively referred to as "treasuries."

Treasury bills, or T-bills, are short-term borrowing instruments. Lenders purchase T-bills at a discounted price, and they are paid the bills' full value when the bills mature. T-bills mature after no more than one year. The term for a note is somewhat longer, ranging from 2 to 10 years. In addition to being paid the face value of the note at the end of the term, the lender also earns an interest payment every six months. A treasury bond is the same as a note, except that bonds are issued only in 30-year terms. Through treasuries the federal government borrows money from individuals, companies, and foreign countries, and agrees to pay it back over time with interest. The amount owed to these lenders is referred to as the publicly held debt.

In addition to borrowing from the public, the federal government also borrows from itself. The Social Security Trust Fund, which accumulates cash through the payroll tax, is the most common source of this "intergovernmental borrowing." Any excess receipts from the payroll tax that are not used to pay for Social Security in a given year go into the trust fund. The trust fund is then invested in special government securities that are similar to the bills, notes, and bonds that the public can purchase. The cash received when the trust fund "buys" the special issue securities is then used by the federal government like any other borrowed dollars—paying for public services costing in excess of revenues. The Social Security Trust Fund earns interest on its investment in the government securities, just as the public does.

Together, the debt owed to the public and the debt owed to other parts of the government is called the total gross federal debt. Both kinds of debt are important and reflect obligations that the government must meet. But the publicly held debt is generally considered to be the more economically significant of the two because the debt owed to the public is legally binding and defaulting on that debt would have very serious, worldwide economic implications. On the other hand, the government's obligations to the Social Security trust fund can be altered by changing the Social Security program, which has happened before.

How big is the debt?

Right now the gross federal debt is almost $12 trillion, of which $7.6 trillion is publicly held. But like the deficit, the best way to measure debt is not in total dollars but as a comparison to the economy's total size, known as the debt-to-GDP ratio. By this measure publicly held debt is about 54 percent of GDP.

As a share of the economy, publicly held debt in 2009 is larger than at any time since 1955, though more recent years have seen debt-to-GDP ratios almost at current levels. In 1993, 1994, and 1995, for example, the debt was between 49 percent and 50 percent of GDP.

Who holds the publicly held debt?

About 60 percent of publicly held debt belongs to Americans. The other 40 percent is held by foreign lenders. China is the largest foreign lender and holds about $800 billion in treasuries (about 11 percent of total publicly held debt), followed closely by Japan at $725 billion (about 10 percent).

China has only recently become the United States' largest lender, overtaking Japan in September 2008. China had been a distant second as recently as 2000, when it held less than 2 percent of all U.S. publicly held debt, compared to Japan's 9 percent. Over the next several years, however, Chinese lenders began purchasing a greater and greater share of U.S. debt offerings, reaching close to 7 percent by the end of 2005 and 10 percent by the beginning of 2008.

No other country currently holds more than 3 percent of total publicly held U.S. debt.

What are the pros and cons of running budget deficits?

A budget deficit is not consistently a good or bad thing. Ordinarily running very large, sustained deficits carries some risks with it, but small deficits may also have some benefits.

Modest borrowing in order to invest in infrastructure improvements, education, or other projects that are likely to improve economic growth over the long term can be justified because the benefits that accrue from the investments will more than pay for the interest incurred on the debt. This is equivalent to when an entrepreneur borrows to start a new business or a family takes out a loan to pay for a child's college education. These are wise uses of borrowed funds, and though the scale of government borrowing is quite different than a business owner or a family, the principle is the same.

There is unwise borrowing as well. Too much debt, for instance, can become an unbearable burden as interest payments grow to take up a larger and larger share of expenses. Furthermore, it is difficult to justify running a deficit to finance spending that is unlikely to produce higher economic growth in the future.

Too much government borrowing can also cause economic problems. Many economists worry that deficits could drive up interest rates and inflation. And long-term deficits could provoke strong reactions from economic actors who seek to protect themselves from the perceived future costs of these deficits, which could in extreme cases spark a financial crisis.

Specific circumstances help determine if borrowing is a good or bad idea. During an economic recession, for example, budget deficits are crucial to help make up for lower private spending and investment. In fact, the near-record deficit in 2009 is due in part to government efforts to combat the serious economic crisis that began in 2007. In the absence of a recession, however, the risks associated with running large and persistent deficits make such a fiscal path both undesirable and unwise.

How big is too big?

There is no defined point at which a deficit becomes dangerous—it depends on the circumstances. During recessions, for example, temporary spikes in borrowing to finance recovery efforts are entirely appropriate even though they can result in rather large deficits.

On the other hand, during good economic times it generally makes sense to reduce the debt-to-GDP ratio by getting as close to fiscal balance as possible. It is important to note, however, that complete balance is not always necessary to accomplish this goal. Small deficits during periods of economic growth can actually lead to a declining debt-to-GDP ratio as long as the rate at which the economy grows is faster than the rate at which the debt grows. Typically, this means deficits well under 3 percent of GDP. In fact, from 1950 to 1974 the debt-to-GDP ratio went down nearly every year, even though the budget was in deficit in 20 out of those 25 years. Those deficits averaged 1 percent of GDP. Of course, the closer to balance a budget is, the faster the debt will decline as a share of the economy.

How do we reduce the deficit?

Since deficits are the gap between spending and income, they can be reduced by decreasing spending, increasing income, or both. Cutting spending would entail scaling back or eliminating existing programs and benefits, while raising additional revenue would mean an increase in taxes and fees.

Deficits can also be reduced through robust economic growth since a rather large portion of the federal government's budget is determined by the economy. For example, total individual income tax receipts are very responsive to ups and downs in the economy. During boom times tax revenues rise as incomes go up. Moreover, fewer people require government services to get by when the economy is expanding and that means lower spending.

Even if economic growth did not produce higher revenues or lower spending, it would still reduce the relative size of the deficit and the risks associated with fiscal gaps. If the deficit stays at the same dollar amount from one year to the next but the economy grows, then the deficit actually shrinks as a share of GDP. Because of these two phenomena—that income rises and spending declines during good economic times and that deficits can shrink as a share of GDP even if their absolute dollar size remains the same—the budget deficit can often be reduced simply by strong economic growth, without changing any policies.