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IN FOCUS

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Deficits and Debt

Net deficits and debt are the primary short- and long-term measurements of federal budget performance, which represents a critical congressional responsibility. This *In Focus* summarizes debt, deficits, and their interaction at the federal level; analyzes recent outcomes and their interaction with the economy; and discusses Congressional options for debt and deficit management.

Fundamental Properties

The federal government incurs a budget deficit when total outgoing payments (outlays) exceed monies collected (revenues). If instead revenues are greater than outlays, the government incurs a surplus. Deficits are measured over the course of the fiscal year, which runs from October 1 through September 30. Net interest payments, which measure inflows and outflows on interest from the federal debt, are included in deficit and surplus outcomes.

Federal debt represents the accumulation of government borrowing activity from private citizens, institutions, and domestic and foreign governments. Debt levels increase when there are budget deficits, net outflows for federal credit programs, or increases in intragovernmental debt (debt that is held in federal government accounts). The Department of the Treasury is tasked with managing debt levels, with the stated intent of doing so in a manner that maximizes transparency and minimizes interest costs.

Policymakers monitor budget and debt outcomes for a number of reasons. Deficits and debt provide measurements of intergenerational equity, or how public goods and services and related payments are assigned across generations. Increases in debt and deficit levels in one time period may constrain the choices available to other periods. Budget and debt outcomes may have ramifications on performance in financial markets, as market exchanges may depend on the perceived credit risk of federal debt. Deficits and debt can also affect economic growth. In prosperous economic periods, deficit spending may replace private investment and, as those deficits will incur borrowing costs, can lower long-run economic potential.

Economic Interaction

Economic expansions are generally correlated with improvements in budget and debt outcomes. Net deficits typically experience a structural decline in periods of high economic growth due to both increased revenues (through a rise in earnings and subsequent tax payments) and reduced outlays (through a decline in demand for unemployment benefits and other income security programs). Reductions in outlays in an expansion may be mitigated by increases in net interest payments if the expansion is characterized by a rise in interest rates. When interest rates are low, net interest payments decline, and vice versa.

As deficits have historically been the largest contributor to debt, the deficit improvements experienced in expansions indirectly reduce debt levels relative to poor economic periods. However, because debt is largely dependent on past federal fiscal outcomes, there may be a lag between a change in economic outcomes and changes in debt levels.

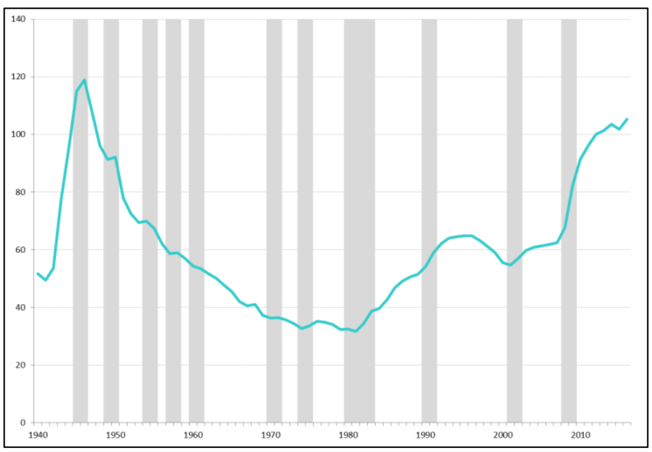
Net deficit and debt levels may in turn affect economic outcomes. Many economists support the use of budget deficits as an economic stimulant during an economic downturn. Though deficit outcomes increase federal debt levels, they may also mitigate downward shocks in demand and employment in such periods.

However, economic experts caution that structural deficits, which describe budget conditions that produce deficits in all economic conditions, may lead to adverse outcomes. Large and persistent deficit or debt levels may reduce public confidence in the government's ability to fulfill its borrowing obligations, which could increase federal borrowing costs and have implications for financial markets. There are past examples of foreign governments experiencing the adverse effects of a deteriorated fiscal position. There are, however, no examples of such an occurrence taking place in modern U.S. history.

Historical Outcomes

Figure 1. Federal Debt, FY1940-FY2016

(As a % of GDP)



Source: OMB, *Historical Tables*, Table 7.1

Notes: Shaded areas represent years with economic recessions.

Figure 1 shows debt outcomes from FY1947 through FY2016. Deficits and federal debt levels reached their historical peak during World War II, as deficits as high as 29.6% of gross domestic product during the war caused federal debt to rise to 120% of GDP at the end of FY1946. (When comparing deficit and debt totals over time, measuring values as a percentage of GDP helps to account for the effects of inflation.) In the ensuing decades, a combination of either budget surpluses or small deficits and robust economic growth caused real debt to steadily decline, reaching a low of 32% of GDP in FY1981.

Real debt levels grew in the following three decades. The federal budget recorded consistent deficits in that time period, except for budget surpluses from FY1998 to FY2001 (caused by economic growth and fiscal restraint). Reduced revenues, increased defense commitments, and gradually increasing mandatory spending contributed to the rise in debt after FY2001. Debt levels then grew sharply in the Great Recession, as deficits from FY2008 through FY2010 were higher than in any other postwar year.

Real deficits have declined steadily in the past few years, reaching a value of 3.2% of GDP in FY2016, though remained higher than the average deficit value of 2.0% of GDP in the postwar period. Large declines in discretionary spending and depressed net interest payments (attributable to low interest rates) have contributed to the decline. Federal debt is estimated to have reached 105% of GDP at the end of FY2016, the highest value since FY1947.

Current Outlook

The January 2017 Congressional Budget Office (CBO) forecast projects deficit increases in the 10-year budget window. Increases in real outlays (through rising mandatory spending commitments) and net interest obligations (through increased real interest rates) more than offset continued inflation-adjusted declines in discretionary spending and relatively steady revenue projections.

Overall, the forecast projected budget deficits of 3.2% of GDP in FY2016 and 4.8% of GDP in 2026. Debt held by the public—all federal debt less intragovernmental debt—is projected to equal 87.0% of GDP in FY2026, which is larger than any historical value since FY1947. (CBO and other agencies often project debt held by the public instead of total federal debt, as the former measures the borrowing that directly affects credit markets.) CBO's July 2016 *Long-Term Budget Outlook* projects government activity over a longer time horizon and estimates publicly held federal debt to be 141% of GDP in FY2046 under present law. **Table 1** shows the latest projected values of federal outlays, revenues, deficits, and debt held by the public.

Current economic conditions offer mixed signals for federal activity. Most economists agree that the economy is close to full employment, with a national unemployment rate of 4.7% as of February 2017. However, the labor force participation rate (measuring the percentage of the population that is either employed or looking for a job) remains lower than expectations. The current economic expansion is the fourth longest in the postwar area, although the growth rate has been lower than in previous expansions. Additional debt financing in expansions may reduce the "fiscal space" available to address future recessions. Fiscal space may be particularly important if a recession takes effect when traditional monetary responses are weakened.

Table 1. Recent and Projected Federal Fiscal Outcomes, FY2016-FY2046
(All figures as a % of GDP)

	FY2016	FY2026	FY2046
Outlays	20.9	23.1	28.2
Revenues	17.8	18.3	19.4
Deficit	3.2	4.8	8.8
Debt Held by the Public	77.0	87.0	141.1

Source: CBO, *The Budget and Economic Outlook: 2017 to 2027*, January 2017, and *The 2016 Long-Term Budget Outlook*, July 2016.
Note: Debt held by the public equals total federal debt less intragovernmental debt.

Congressional Management

Perhaps the most significant law modifying budget outcomes at the start of the 115th Congress is the Budget Control Act (BCA; P.L. 112-25). Signed into law in 2011, the BCA was originally estimated to reduce deficits by $2.1 trillion from FY2013 to FY2021, primarily through caps on discretionary budget authority.

Subsequent legislation raised the caps in FY2013 through FY2017. FY2017 cap levels are set at a combined value of $1.070 trillion, a small increase from the $1.066 trillion level in FY2016; that value is scheduled to decrease to $1.064 trillion in FY2018. Other options to modify budget outcomes introduced in recent Congresses include pay-as-you-go requirements for new legislation, mandatory spending reform efforts, and tax reform proposals.

Federal debt levels are managed through the statutory debt limit, which places a nominal (dollar) cap on the permissible level of federal borrowing. The federal debt limit acts as a check to ensure that recent revenue and expenditure trends meet the approval of Congress. However, federal obligations affecting debt levels may have been agreed to well in advance of a nearly binding debt limit. In the past, Congress has linked debt limit increases with legislation that seeks to improve future budget outcomes.

The Bipartisan Budget Agreement of 2015 (BBA 2015; P.L. 114-74) suspended the debt limit through March 15, 2017. That law calls for the debt limit to be increased upon reinstatement to exactly accommodate any increases in federal borrowing undertaken during the suspension period. If Congress is faced with a nearly binding debt limit upon its reinstatement, it may choose to (1) leave the debt limit in place; (2) authorize the invocation of "extraordinary measures" to postpone a binding debt limit; or (3) increase or suspend the debt limit. Possible consequences of a binding debt limit include increased future borrowing costs, financial market shocks, and reduced economic growth.

Grant A. Driessen, Analyst in Public Finance

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