AARP Public Policy Institute

Celebrating 20 Years 1985 2005

DATA DIGEST

BUDGET SURPLUSES (DEFICITS) AND THE FEDERAL DEBT: HOW ARE THEY LINKED?

Introduction

After decades of deficits, the federal unified budget achieved a small surplus in FY1998 and larger surpluses the following three fiscal years, thanks in part to the longest period of sustained economic growth in U.S. history.[1] In 2002, however, a deteriorating economy, the 2001 tax cuts, and the cost of the nation's response to the September 11 terrorist attacks produced a sea change in the near- and long-term budget outlook. The surplus environment quickly gave way to a deficit scenario (Table 1). For FY2004, the unified budget contained a deficit of $412 billion, or 3.6 percent of gross domestic product (GDP). This compares with a unified surplus of $236 billion for FY2000 (2.4 percent of GDP) and $127 billion for FY2001 (1.3 percent of GDP).

According to the Congressional Budget Office (CBO), the shift from a unified budget surplus to a projected unified budget deficit for the next nine years reflects several dominant factors: a decrease in federal revenue caused by a weakening economy; the cost of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (a 10-year, $1.35 trillion tax cut enacted in 2001) and The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) which added another half trillion or so; and increased federal spending, particularly for defense and homeland security.

Just three years ago, the nation faced an historic choice about how to use projected huge surpluses. The evaporation of these surpluses and the fact that the only projected surpluses now are off-budget—mostly Social Security (over 97 percent) and Postal Service funds—raises critical policy concerns about our ability to apply Social Security surpluses to paying down a portion of the public debt. Reducing the public debt is a form of national saving that leads to increased investment and national income, ultimately making it easier to pay future Social Security benefits.

Table 1: Federal Budget and Debt ($b)

Fiscal Year	Unified Surplus/ Deficit	Debt Held by Public	Gross Federal Debt
1999	126	3,633	5,606
2000	236	3,410	5,629
2001	127	3,174	5,625
2002	-158	2,947	5,664
2003	-375	3,914	6,760
2004	-412	4,296	7,355

Source: CBO, 2005

The reversal of the nation's fiscal fortunes and the need to use the Social Security surplus for priorities other than debt reduction will hamper our long-run ability to pay for future Social Security and Medicare obligations. This will make it more difficult for policy makers to find ways to improve the future solvency of both programs, which are projected to have long-term financing imbalances—Social Security is projected by the Social Security trustees to be insolvent in 2042 and Medicare in 2030.[2]

The purpose of this *Data Digest* is to explain the relationship between federal debt and budget deficits or surpluses from an accounting perspective. Special attention is given to the role of the Social Security trust funds in government accounting procedures as well as budget and debt policy.

What Is a Unified Budget?

The unified federal budget is composed of on-budget transactions (federal funds and trust funds except the Social Security and Postal Service trust funds) and off-budget transactions (mostly Social Security trust funds). Because Social Security has its own funding source and was building sizable reserves, legislation adopted in 1990 separated it from the rest of the budget by taking Social

[1] FY1998–FY2001 were the first four consecutive surplus years in over 60 years. The surpluses totaled $558 billion over this period—$69 billion in 1998, $129 billion in FY1999, $236 billion in FY2000, and $127 billion in FY2001.

[2] Social Security is not a pure pay-as-you-go system in which revenues exactly equal outlays in each year. Currently its revenues (including interest) exceed outlays by 14 percent.

Sources: CBO, 2003, 2005

Security revenues, spending, and trust fund surpluses "off-budget." This required that the calculation of the federal budget deficit or surplus be adjusted in both the President's and Congress's budgets. But despite the 1990 legislation, both the administration and Congress have continued to present the "unified" budget. The CBO, the U.S. General Accounting Office (GAO) (1998), and other agencies that produce budget documents and analyses think that the unified budget concept gives the most complete picture of total federal revenues, spending, surpluses, and deficits.

Over the past decade, the on-budget account has changed dramatically, from a $321 billion deficit in FY1991 to an $87 billion surplus in FY2000 back to a deficit of about $567 billion in FY2004. During the same period, the off-budget surplus has grown from $53 billion in FY1991 to $155 billion in FY2004. According to CBO, if current law continues, despite an off-budget (mostly Social Security) surplus of up to $310 billion during the next decade, the unified budget is projected to remain in deficit through 2011 (Figure 1).

What Is Federal Debt?

The total outstanding debt of the federal government, often referred to as "gross federal debt," is composed of intragovernmental debt that the government owes to itself and debt held by the public. The latter is the value of all federal securities that have been sold to the public and are outstanding. Debt held by the government consists mainly of special-issue Treasury bonds held in the Social Security trust funds and in other government accounts, such as Civil Service Retirement, Military Retirement, Medicare, and Unemployment Insurance trust funds (Table 2).

Table 2: Components of Gross Federal Debt and Federal Budget ($ billions)

	FY2003	FY2004
Federal Budget		
On-Budget	-536	-567
Off-Budget	161	155
Unified Budget	**-375**	**-412**
Federal Debt		
1. Publicly Held Debt	3,914	4,296
2. Intragovernmental Debt	2,846	3,059
(a) Social Security	1,484	1,635
(b) Other Govt. Accounts	1,362	1,424
Gross Federal debt	**6,760**	**7,355**

Source: CBO, 2005

Current law requires that Social Security funds be dedicated exclusively to the program's obligations and that any surplus funds be lent to the U.S. Treasury. The Social Security trust funds in turn are credited with special-issue Treasury bonds. In times of unified budget deficits, the Treasury borrows funds from Social Security to meet government obligations. In times of unified budget surpluses, the Treasury borrows funds from Social Security to reduce publicly held debt (AARP, 2004).

The federal budget includes more than 150 trust funds, the largest being Social Security trust funds. During the 1990s, gross federal debt increased more than 50 percent, from $3.6 trillion in FY1991 to $5.6 trillion in FY2000. In addition, the sources of gross federal debt changed dramatically. The

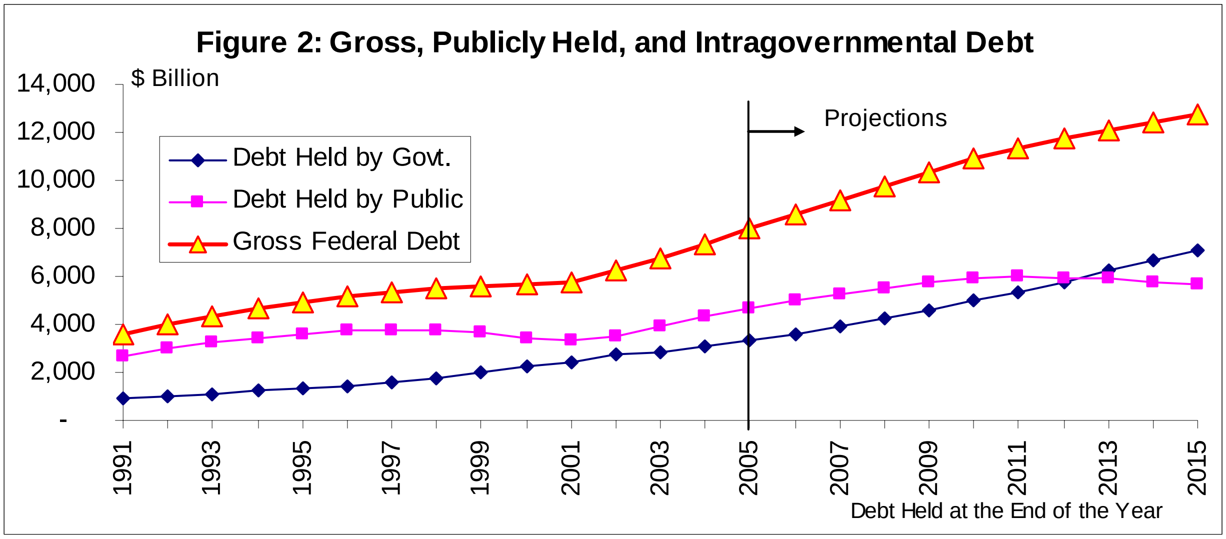

Figure 2: Gross, Publicly Held, and Intragovernmental Debt

Source: CBO, 2005

Figure 3: Effect of Budget Surplus (Deficit) on Debt (billions of dollars)

Federal Debt: End of FY2003

(1) Publicly Held Debt = 3,914

(2) Intragovernmental = 2,846
(a+b)
(a) Social Security = 1,484
(b) Other Govt. Accounts = 1,362

(3) Gross Federal Debt = 6,760
(1+2)

a. *Mainly the civil service retirement, unemployment insurance, military retirement, and Medicare trust funds.*

Budget Surplus (Deficit) FY2004

Unified Budget	= -412
On-Budget	= -567
Off-Budget	= 155
Soc. Sec. Trust Funds	= 151
Postal Services	= 4
Other Means Of Financing	= -30
Other Govt. Accounts [a]	= +62

Federal Debt: End of FY2004

(1) Publicly Held Debt	**= 4,296**
FY2003	= 3,914
+ Unified Budget FY2004	= 412
+ Other Means of Financing	= -30
(2) Intragovernmental (a+b)	**= 3,059**
(a) Social Security	= 1,635
FY2003	= 1,484
+ FY 2004	= 151
(b) Other Govt. Accounts	= 1,424
FY2003	= 1,362
+ FY2004	= 62
(3) Gross Federal Debt (1+2)	**= 7,355**

first half of the 1990s was characterized by significant growth in publicly held debt, which expanded from $2.7 trillion in FY1991 to $3.7 trillion in FY1996. This debt leveled off by FY1997, but in the past two years (FY2003–FY2004), it has started rising again. As public debt leveled off, gross federal debt continued to climb as a result of growing intragovernmental debt (mainly the Social Security trust funds) and the return to on-budget deficits (Figure 2).

How Is the Budget Surplus/Deficit Linked to Federal Debt?

This section explains how budget surplus (deficit) and debt numbers for FY2003 and FY2004 are linked in the accounting sense. The debt balance at the end of FY2003 becomes the debt balance at the beginning of FY2004. As shown in Figure 3, the unified budget deficit of $412 billion plus the other means of financing of - $30 billion for FY2004 are added to the publicly held debt of $3,914 billion in FY2003 to become $4,296 billion at the end of FY2004.

The annual off-budget surplus ($151 billion) due to the Social Security trust funds (as shown in the second box), is added to the Social Security trust funds reserves of $1,484 billion (FY2003) to become $1,635 billion at the end of FY2004. Similarly, $62 billion in other government accounts is added to the $1,362 billion already held in those accounts at the end of FY2003 to become $1,424 billion in FY2004. The intragovernmental debt ($3,059) in FY2004 is the sum of the Social Security ($1,635 billion) and other government accounts ($1,424 billion). The intragovernmental debt, when added to public debt ($4,296 billion) becomes the gross federal debt ($7,355 billion) for FY2004. Public debt and intragovernmental debt at the end of FY2004, in turn, become the beginning balances of FY2005, and so on.

The amount of debt held by the trust funds sets an aggregate limit on how much can be spent. Most trust funds hold U.S. Treasury securities; they represent total assets for a specific program (such as Social Security) but not assets of the government as a whole.[3] When there is an off-budget surplus, less will be borrowed by the Treasury in terms of public debt. In our case for FY2004, the Treasury has to borrow $412 billion instead of $567 billion, or $155 billion less (see Table 2). This off-budget surplus is credited to the intragovernmental account. If we had an off-budget deficit of $155 billion instead of a surplus (not in shown in Figure 3), the unified budget deficit would have been higher by $155 billion ($567+$155 = $722 billion) and the publicly held debt would have increased to $4,606 billion, or by $310 billion more. Intragovernmental funds would not have received these sums, and the Treasury would have to borrow more from the public. The unified budget (which includes both the on- and off-budget surplus/deficit) affects only the debt held by the public. A unified deficit would increase this debt, while a unified surplus would decrease it.[4] The off-budget surplus, on the other hand, simply represents the intragovernmental debt (i.e., from one department of the government to another).

Why does the off-budget surplus become part of intragovernmental debt? Even though current law requires that Social Security funds be used exclusively for Social Security programs, Social Security surpluses (when trust funds receive taxes that are not currently needed to pay benefits) are required by law to be lent to the Treasury to meet government obligations, for which the Social Security trust funds are credited with special-issue Treasury bonds. These bonds, in turn, increase the intragovernmental debt

[3] When trust funds fall short of their expenses, government raises necessary funds by borrowing more than it otherwise would, which in turn requires the Treasury to obtain cash through public borrowing.

[4] From an economic perspective, the debt affects the budget because it requires annual outlays to pay interest to public holders of government securities.

Conclusions

Alternative perceptions of budget definitions have important implications for the presentation of budget data, including measuring the size of any budget surplus and the federal debt. Unified budget figures that include large Social Security surpluses tend to hide the size of any on-budget surplus or deficit. This is especially misleading when ten-year budget projections become the basis for long-term policy commitments.

Unified budget deficits increase public debt, while unified budget surpluses decrease public debt but increase the intragovernmental debt if there is an off-budget surplus. Both the intragovernmental debt and the public debt constitute gross federal debt. In FY2004, the net change in the unified budget (a deficit of $412 billion) increased publicly held debt, while the off-budget surplus ($155 billion) increased the intragovernmental debt; thus, both added to the gross federal debt. If there are both on-budget and off-budget surpluses, both public debt from previous year and gross federal debt will decline.

Understanding the federal budget from an accounting perspective is important for grasping the relationships between budget surpluses/deficits and the federal debt. Finally, budget accounting conventions help to frame the policy issues surrounding Social Security reform, national savings, and the effects of government borrowing on the economy.

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