Deficit

REVIEWED BY WILL KENTON | Updated Feb 12, 2018

What is a {term}? Deficit

A deficit is the opposite of a surplus. It is the amount by which a resource falls short of a mark. Most often used to describe a difference between cash inflows and outflows, it is synonymous with shortfall or loss – the amount by which expenses or costs exceed income or revenues.

BREAKING DOWN Deficit

A trade deficit exists when a nation's imports exceed its exports. For example, if a nation imports $3 billion in goods but only exports $2 billion, the nation has a trade deficit of $1 billion for that year. The implication is that there is more in terms of value entering the country (being bought) than there is leaving the country (being sold). As a result, the country owes more to other countries than it is owed by other countries.

A trade deficit can cause a drop in a domestic currency's value and a reduction in domestic jobs. Some people believe that trade deficits are a result of global competition, which provides consumers with greater choice in products.

Assume the small island of Yota has abundant resources. It uses them to meet almost all of its citizens' needs. It also uses its resources to build a factory to make surfboards. This is the only item that Yota exports. The one resource Yota does not have is oil, and it needs oil to generate electricity for its citizens and the surfboard factory. If Yota imports $1 million of oil in a year, but only exports $600,000 worth of surfboards, Yota will have a trade deficit of $400,000. Note that the only way for Yota to have this trade deficit is if other countries are willing to allow the island to borrow funds to finance the $400,000 debt.

deficit might also motivate a country to take actions that would ultimately eliminate the deficit while providing benefits. For example, Yota's government could encourage research and development in alternative energy to reduce its oil dependency.

Budget Deficits

A budget deficit refers to the balance sheet of a business or, more typically, a government. A budget deficit indicates that the entity's revenues are lower than its expenditures. If a small country has $10 billion worth of revenue for a year, and its expenditures were $12 billion for that same year, the country would be running a deficit of $2 billion.

With a budget deficit, governments have less money and fewer options for future endeavors. If they have borrowed money to cover the shortfall, they often must pay interest on loans or bonds. Government budget deficits used to be financed exclusively by loans from private investors and foreign countries. These loans were often seen as holding substantial risk for the lender because they were often both large and long term. When governments began to issue bonds pay to bearer, the original lender could sell the debt reducing risk and interest rates.

Budget deficits aren't always inadvertent. Businesses may run budget deficits to maximize future earning opportunities such as retaining employees during slow months or to ensure an adequate workforce in busier times. Some governments run deficits to finance public projects and maintain programs for their citizens.

Income Deficits

An income deficit is a measurement used by the U.S. Census. It represents the dollar amount by which a family's income falls short of the poverty line. If the poverty line is $17,000 a year for a family of three, and the family income is at $15,000, then the family's income deficit is $2,000.

Measuring Deficits

Deficits can be estimated in different ways. For example, a government's deficit can be measured in two ways. A primary deficit refers to the shortfall without including interest payments on loans used to finance government operations. Total deficit includes the interest payments on loans.

Deliberately Running a Deficit

During a recession, a government may intentionally run a deficit by decreasing sources of revenue, such as taxes, while maintaining or even increasing expenditures, infrastructure, for example, which provide employment and income. The theory is that these measures will boost the public's purchasing power, which stimulates the economy. In fact, Keynesian economists argue that it is the responsibility of the government to assist the economy and smooth out the ups and downs of the business cycle. These economists consider debt acceptable deficit spending.

The Ricardian equivalence hypothesis, originally developed by British Parliament member and economist David Ricardo, argues that households will keep the money saved from tax cuts instead of spending it, possibly because they anticipate a future rise in taxes brought on by the government debt. However, for Ricardian equivalence to apply, the deficit spending would have to be permanent as opposed to a one-time stimulus.

Another theory, called crowding out, warns that serious consequences could result from deficit-financed spending. Developed in the 1970s, this school of thought maintains that when a government borrows to offset a deficit, interest rates tend to rise, which decreases the incentive for businesses to expand and invest. Increased spending and lending by the government can create a "crowding out" effect by competing with private spending and financing.

The Risks of Running a Deficit

deficits, the negative effects include lower economic growth rates (in case of budget deficits) or a devaluation of the domestic currency (in case of trade deficits).

However, the experience of governments that have run persistent deficits in the 20th and 21st centuries have complicated the Ricardian and neo-classical analyses of the effect of government debt on economic activity. The Great Recession, which drove up government deficits across the world from 2008 to 2013, led many neo-classical economists to speculate that government budgets would collapse under the weight of persistent spending deficits. In fact, Harvard economists Carmen Reinhart and Kenneth Rogoff predicted in 2010 that government debt above 90% of GDP would actively retard economic growth. (Researchers at the University of Massachusetts later discovered a coding error in the Excel spreadsheet Reinhart and Rogoff used that invalidated the pair's conclusion).

The U.S. Budget Deficit

At times, the U.S. budget deficit has been large while, at other times, the budget has achieved a balance or a surplus. The reasons for deficits vary, and there is constant debate concerning the cause of deficits. The size of the current shortfall ($440 billion for fiscal year 2018) and its potential impact in our increasingly globalized economy has caused the deficit to be a polarizing issue.

Carrying a deficit balance on the U.S. budget is similar to a long-term loan but on a much larger scale. With a balanced budget, the government spends tax receipts and other sources of revenue in amounts roughly equal to the amount it receives. Unfortunately, it is difficult to carry a balanced budget when a country must make payments for national services, programs, defense, and other domestic and foreign expenditures.

If there is a shortfall, the government has several options. It can either print new currency or finance the debt with government bills, notes and bonds. Cutting spending and raising taxes are also options, but they are difficult to implement, particularly when the spending needs that helped create the deficit are pressing. Issuing more money can create inflation while issuing bills or bonds can widen the deficit as the cost of the debt payments mounts. While neither option is desirable, they both may be necessary to battle a deficit.

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