ARBITRARINESS OF DEFINING DEFICITS AND SURPLUSES

Whether or not you have a deficit or surplus depends on what you count as a revenue and what you count as an expenditure. These decisions can make an enormous difference in whether you have a surplus or deficit. For example, consider the problem of a firm with annual revenues of $8,000 but no expenses except a $10,000 machine expected to last five years. Should the firm charge the $10,000 to this year’s expenditures? Should it split the $10,000 evenly among the five years? Or should it use some other approach? Which method the firm chooses makes a big difference in whether its current budget will be in surplus or deficit.

Accounting is central to the debate about whether we should be concerned about a deficit. Say, for example, that the government promises to pay an individual $1,000 ten years from now. How should government treat that promise? Since the obligation is incurred now, should government count as a current expense an amount that, if saved, would allow it to pay that $1,000 later? Or should government not count the amount as

an expenditure until it actually pays out the money? The Social Security system—a social insurance program that provides financial benefits to the elderly and disabled and to their eligible dependents and/or survivors—is based on promises to pay, and thus the accounting procedures used for Social Security play an important role in how big the government’s

budget deficit actually is.

**MANY RIGHT DEFINITIONS**

Many accounting questions must be answered before we can determine the size of a budget

deficit. Some have no right or wrong answer. For others there are right or wrong answers

that vary according to the wording of the question being asked. For still others, an

economist’s “right way” is an accountant’s “wrong way.” In short, there are many ways to

measure expenditures and receipts, so there are many ways to measure surpluses and deficits.

To say that there are many ways to measure deficits is not to say that all ways are

correct. Pretending to have income that you don’t have is wrong by all standards. Similarly,

inconsistent accounting practices—such as measuring an income flow sometimes

one way and sometimes another—are wrong. Standard accounting practices rule out a

number of “creative” but improper approaches to measuring deficits. But even eliminating

these, there remain numerous reasonable ways of defining deficits, which account

for some of the debate.

**NOMINAL AND REAL DEFICITS AND SURPLUSES**

Another distinction that economists make when discussing the budget deficit and surplus

picture is the real/nominal distinction. A **nominal deficit** is *the deficit determined by*

*looking at the difference between expenditures and receipts.*1 It’s what most people think of

when they think of the budget deficit; it’s the value that is generally reported. The **real**

**deficit** is *the nominal deficit adjusted for inflation*. To understand this distinction it is important

to recognize that inflation wipes out debt (accumulated deficits less accumulated

surpluses). How much does it wipe out? Consider an example: If a country has a

$2 trillion debt and inflation is 4 percent per year, the real value of all assets denominated

in dollars is declining by 4 percent each year. If you had $100 and there’s 4 percent

inflation in a year, that $100 will be worth 4 percent less at the end of the

year—the equivalent of $96 without inflation. By the same reasoning, when there’s

4 percent inflation, the value of the debt is declining 4 percent each year. Four percent

of $2 trillion is $80 billion, so with an outstanding debt of $2 trillion, 4 percent inflation

will eliminate $80 billion of the debt each year.

The larger the debt and the larger the inflation, the more debt will be eliminated by

inflation. For example, with 10 percent inflation and a $2 trillion debt, $200 billion

of the debt will be eliminated by inflation each year. With 10 percent inflation and a

$4 trillion debt, $400 billion of the debt would be eliminated.

If inflation is wiping out debt, and the deficit is equal to the increases in debt from

one year to the next, inflation also affects the deficit. Economists take this into account

by differentiating nominal deficits from real deficits.

We can calculate the real deficit by subtracting the decrease in the value of the government’s

total outstanding debts due to inflation. Specifically:2

**DEBT MANAGEMENT**

The U.S. government, through its Treasury Department, must continually refinance the

bonds that are coming due by selling new bonds, as well as sell new bonds when running

a deficit. This makes for a very active market in U.S. government bonds, and the interest

rate paid on government bonds is a closely watched statistic in the economy. If

the government runs a surplus, it can either retire some of its previously issued bonds

by buying them back or simply not replace the previously issued bonds when they

come due.