Center on Budget and Policy Priorities

POLICY BASICS

DEFICIT, DEBT, AND INTEREST

"Each time the government runs a deficit, it increases the national debt; each time the government runs a surplus, it shrinks the debt."

Policy Basics is a series of brief background reports on issues related to budgets, taxes, and government assistance programs.

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Three important terms regarding the federal budget — **deficits**, **debt**, and **interest** — are often misunderstood.

Deficits

For any given year, the federal budget deficit is the amount of money the federal government spends (also known as outlays) minus the amount of money it takes in (also known as revenues). If the government takes in *more* money than it spends in a given year, the result is a surplus rather than a deficit.

When the economy is weak, people's incomes decline, so the government collects less in tax revenues. This is one reason why the deficit often grows during recessions. Conversely, when the economy is strong and tax revenues increase, the budget deficit shrinks.

Debt

Unlike the deficit, which drives the amount of money the government has to borrow in any single year, the national debt is the *cumulative* amount of money the government has had to borrow throughout our nation's history. Each time the government runs a deficit, it increases the national debt; each time the government runs a surplus, it shrinks the debt.

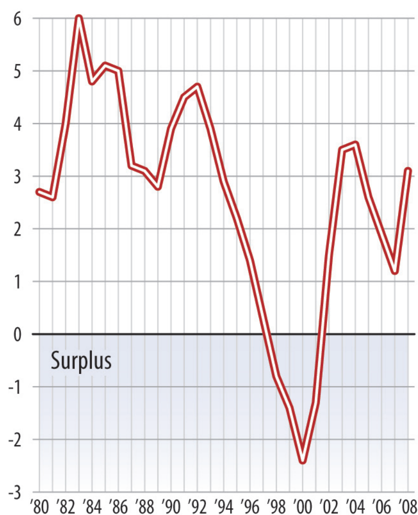
There are two common measures of the national debt:

- **Net debt**, also called debt held by the public, measures the government's borrowing from the private sector (including banks and investors) and foreign governments.
- **Gross debt** is net debt plus the debts the Treasury owes to U.S. government trust funds. For example, each year Social Security takes in more money in payroll taxes than it distributes in benefits; the amounts not needed to pay current benefits are invested in Treasury bonds and the Treasury uses the proceeds to help pay for government operations. As a result, the Treasury owes money to the Social Security trust fund that will be repaid when Social Security needs it to pay future benefits. This type of debt is counted in the gross national debt but not in the net debt.

Net debt is the best measure of the effect of debt on the economy because it reflects the interaction between the government as a whole and the private sector. When the net debt is particularly large — that is, when the government is borrowing large amounts of money from the private sector — less capital is available for private firms to borrow, which can lead to less investment and slower economic growth over the long term.

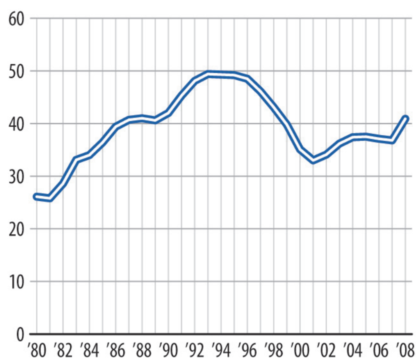
Deficit

As a percent of GDP



Debt Held by the Public

As a percent of GDP



High net debt can also cause part of the profits from economic growth to flow overseas. Foreigners owned fully half the United States' $5.4 trillion in net debt as of July 2008.

Interest

Interest, the fee a lender charges a borrower for the use of the lender's money, is the true cost of government borrowing. This cost is considerable. In 2008 the federal government paid roughly $250 billion in interest payments, or roughly the amount that it spent on education, transportation, and veterans' programs *combined*.

Interest costs reflect both the amount of money borrowed (also known as the principal) and the interest rate. When interest rates go up or down, interest costs do too, making the national debt a bigger or smaller drain on the budget.

Every dollar the government spends on interest payments is a dollar that is unavailable for programs that currently benefit taxpayers. Rather, interest is what we pay now for benefits received in the past. Adding to the national debt by running up deficits essentially shifts the costs of current programs on to future generations, who will have to pay the interest costs.

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