

Deficits, Debt, and Interest

Three important budget concepts are deficits (or surpluses), debt, and interest. For any given year, the federal budget deficit is the amount of money the federal government spends minus the amount of revenues it takes in. The deficit drives the amount of money the government has to borrow in any single year, while the national debt is the *cumulative* amount of money the government has borrowed throughout our nation's history; essentially, the net amount of all government deficits and surpluses. The interest paid on this debt is the cost of government borrowing.

Deficits (or Surpluses)

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 collects from taxes (also known as revenues). If the government collects *more* revenue than it spends in a given year, the result is a surplus rather than a deficit. The 2017 budget deficit was \$665 billion (3.5 percent of gross domestic product, or GDP) — down significantly from levels it reached in the Great Recession and its immediate aftermath.

When the economy is weak, people's incomes decline, so the government collects less in tax revenues and spends more for safety net programs such as unemployment insurance. This is one reason that deficits typically grow (or surpluses shrink) during recessions. Conversely, when the economy is strong, deficits tend to shrink (or surpluses grow).

Recessions aren't the only causes of deficits. A government may also face a structural deficit, or one that would exist even if the economy were operating at full capacity, with high employment.

Economists generally believe that increases in the deficit resulting from an economic downturn perform a beneficial "automatic stabilizing" role, helping moderate the downturn's severity by cushioning the decline in overall consumer demand. In contrast, when the government runs structural deficits and borrows large amounts of money even in good economic times, that borrowing is much more likely to have harmful effects on private credit markets and hurt economic growth over the long term.

Debt

Unlike the deficit, which drives the amount of money the government borrows in any single year, the debt is the *cumulative* amount of money the government has borrowed throughout our nation's history. When the government runs a deficit, the debt increases; when the government runs a surplus, the debt shrinks.

There are two common measures of the debt:

- **Debt held by the public** (sometimes called net debt) measures the government's borrowing from the private sector (including banks and investors) and foreign governments. At the end of 2017, debt held by the public was \$14.7 trillion.
- **Gross debt** is debt held by the public plus the securities the Treasury issues to U.S. government trust funds and other special government funds, such as the Federal Deposit Insurance Corporation (FDIC) — that is, money that one part of the government lends to another. For example, in 2017 the Social Security trust funds collected \$47 billion more in payroll taxes and other income than they distributed in benefits. Each year, the amounts not needed to pay current benefits are invested in Treasury bonds and the Treasury uses those proceeds to help pay for government operations. As a result, the Treasury owes money to the Social Security trust funds and will repay it when Social Security needs the money to pay future benefits. At the end of 2017, Social Security, Medicare, and other government trust and special funds held \$5.5 trillion of Treasury securities, bringing gross debt to \$20.2 trillion.

Debt held by the public is a far better measure of debt's effect on the economy because it reflects the demands that the government is placing on private credit markets. (When the Treasury issues bonds to Social Security and other government trust and special funds, by contrast, that internal transaction does not affect the credit markets.) Further, the debt held by the public is a better measure of the government's *net financial position*; while the amounts the Treasury borrows from government trust and special funds are real liabilities of the Treasury, they are also real assets of the government trust and special funds.

The chart below shows deficits and debt relative to the size of the economy (as measured by GDP). The budget does not have to be balanced to reduce the significance of the debt. For example, even though there were deficits in almost every year from the end of World War II through the early 1970s, debt grew much more slowly than the economy, so the debt-to-GDP ratio fell dramatically.

Debt held by the public was 77 percent of GDP in 2017. That ratio is more than double what it was in 2007, with the jump largely resulting from the Great Recession and efforts to mitigate its impact. Under current budgetary policies, the debt-to-GDP ratio is expected to rise about 17 percentage points over the coming decade and continue rising over the subsequent decades as well. That's largely due to the aging of the population and increases in health and interest costs, which will cause spending to grow faster than GDP, while revenues generally grow proportionally to GDP. Recently enacted legislation — primarily the 2017 tax

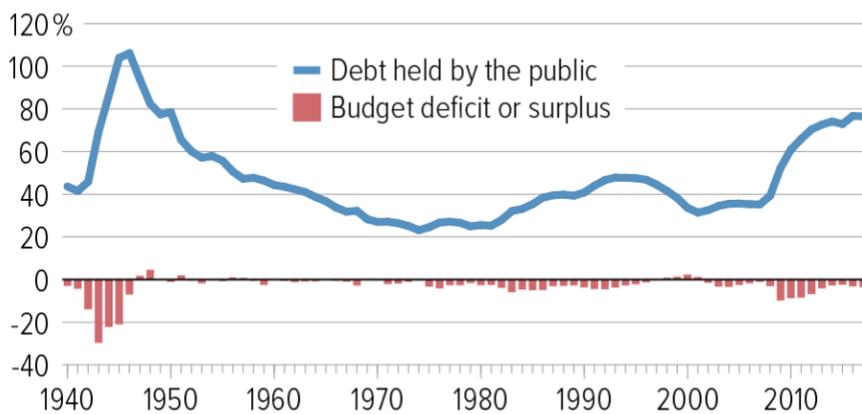
Policy Basics – Deficits, Debt, and Interest

law – reduced projected revenues as a share of GDP, contributing to an increase in the projected growth in debt. (For more, see [Federal Spending and Revenues Will Need to Grow in Coming Years, Not Shrink.](#))

The ratio is currently high by historical standards, leading some policymakers and analysts to call for more deficit reduction in order to lower the debt ratio. Too much deficit reduction too fast is harmful to an economy that is not at full strength, but economists generally believe that the debt ratio should be stable or declining when the economy is strong.

Budget Deficits and Debt Held by the Public

Percent of GDP



Source: Office of Management and Budget, Historical Tables 7.1 and 1.3

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Interest

Interest, the fee a lender charges a borrower for the use of the lender's money, is the cost of government debt. Interest costs are determined by both the amount of money borrowed (also known as the principal) and the interest rate. When interest rates rise or fall, interest costs generally follow, making the debt a bigger or smaller drain on the budget.

In 2017 the federal government paid \$263 billion in net interest. Federal net interest costs, which have been held down by very low interest rates in the Great Recession and its aftermath, amounted to 1.4 percent of GDP and 6.6 percent of government spending in 2017. Both of these figures are well below their average levels over the last 50 years. But interest costs – in dollar terms, as a percent of GDP, and as a share of the budget – will increase as debt continues to grow and interest rates return to more normal levels.

The Debt Limit

Congress exercises its constitutional power over federal borrowing by permitting the Treasury to borrow as needed, but also imposing a legal limit on the amount of money that the Treasury can borrow to finance its operations. The debt subject to that limit differs only slightly from the gross debt. Thus, it combines debt held by the public with the Treasury securities held by government trust and special funds.

Once the debt limit is reached, the government must raise the debt limit, suspend the debt limit from taking effect, violate the debt limit, or default on its legal obligation to pay its bills. Congress has raised or suspended the debt limit more than 90 times since 1940.

Raising or suspending the debt limit does not directly alter the amount of federal borrowing or spending going forward. Rather, it allows the government to pay for programs and services that Congress has already approved.

Nor is the need to raise or suspend the debt limit a reliable indicator of the soundness of budget policy. For example, Congress had to raise the debt limit more than 30 times between the end of World War II and the mid-1970s, even though the debt-to-GDP ratio fell very significantly over this period. Similarly, debt subject to limit rose in the late 1990s – even though the budget was in *surplus* and debt held by the public was *shrinking* – because Social Security was also running large surpluses and lending them to the Treasury.

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For more information on deficits, debt, and interest, see:

Policy Basics: The “Pay-As-You-Go” Budget Rule

<https://www.cbpp.org/research/federal-budget/policy-basics-the-pay-as-you-go-budget-rule>

Policy Basics: Where Do Our Federal Tax Dollars Go?

<https://www.cbpp.org/research/federal-budget/policy-basics-where-do-our-federal-tax-dollars-go>

Long-Term Budget Outlook Has Improved Significantly Since 2010 But Remains Challenging

<https://www.cbpp.org/research/federal-budget/long-term-budget-outlook-has-improved-significantly-since-2010-but-remains>