Center on Budget and Policy Priorities

POLICY BASICS

# Deficits, Debt, and Interest

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Three important budget concepts — **deficits (or surpluses), debt, and interest** — are often misunderstood.

## 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 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. The 2015 budget deficit was $438 billion (2.5 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 why the deficit typically grows (or a surplus shrinks) during recessions. Conversely, when the economy is strong, the deficit tends to shrink (or a surplus grows).

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 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 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. When the government runs a deficit, it increases the national debt; when the government runs a surplus, it shrinks the debt.

There are two common measures of the national 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 2015, debt held by the public was $13.1 trillion.
- **Gross debt** is debt held by the public plus the securities the Treasury issues to U.S. government trust funds — that is, money that one part

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

The Center on Budget and Policy Priorities
820 First Street, NE, Suite 510
Washington, DC 20002
Ph: 202-408-1080
Fax: 202-408-1056
center@cbpp.org
http://www.cbpp.org

of the government lends to another. For example, each year Social Security takes in more money in payroll taxes and other income 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 and will repay it when Social Security needs the money to pay future benefits. At the end of 2015, Social Security, Medicare, and other trust funds held $5.0 trillion of Treasury securities, bringing gross debt to $18.1 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 trust funds, by contrast, that internal transaction does not affect the credit markets.)

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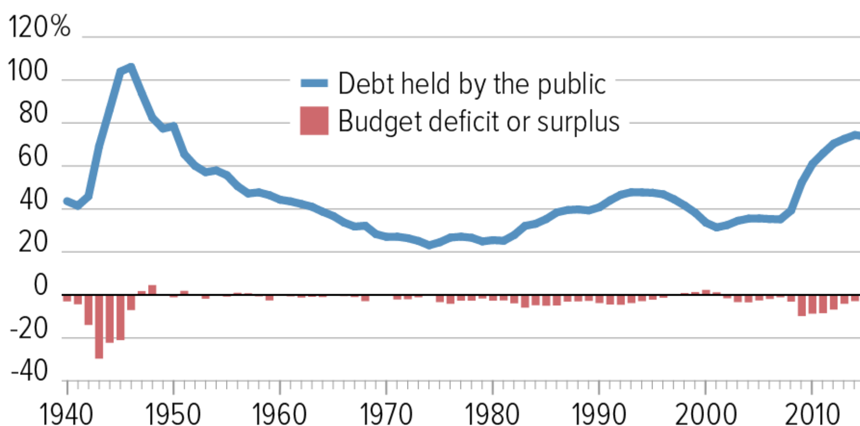
**Budget Deficits and Debt Held by the Public**

Percent of GDP




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

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The chart above 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 economic burden of the debt. For example, even though there were deficits in almost every year between World War II and 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 74 percent of GDP in 2015. 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 10 percentage points over the coming decade and continue rising over the subsequent decades as well. The ratio is currently high by

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

## Interest

Interest, the fee a lender charges a borrower for the use of the lender's money, is the cost of government borrowing. 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 national debt a bigger or smaller drain on the budget.

In 2015 the federal government incurred $223 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 1.3 percent of GDP and 6.1 percent of government spending in 2015. Both of these figures are near their lowest 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 imposing a legal limit on the amount of money that the federal government 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 U.S. government trust funds.

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

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

Nor is the need to raise the debt limit a reliable indicator of the soundness of budget policy. For example, Congress had to raise the debt limit a number of times between the end of World War II and the mid-1970s, even though the debt-to-GDP ratio fell 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.