BUDGET COMMITTEE

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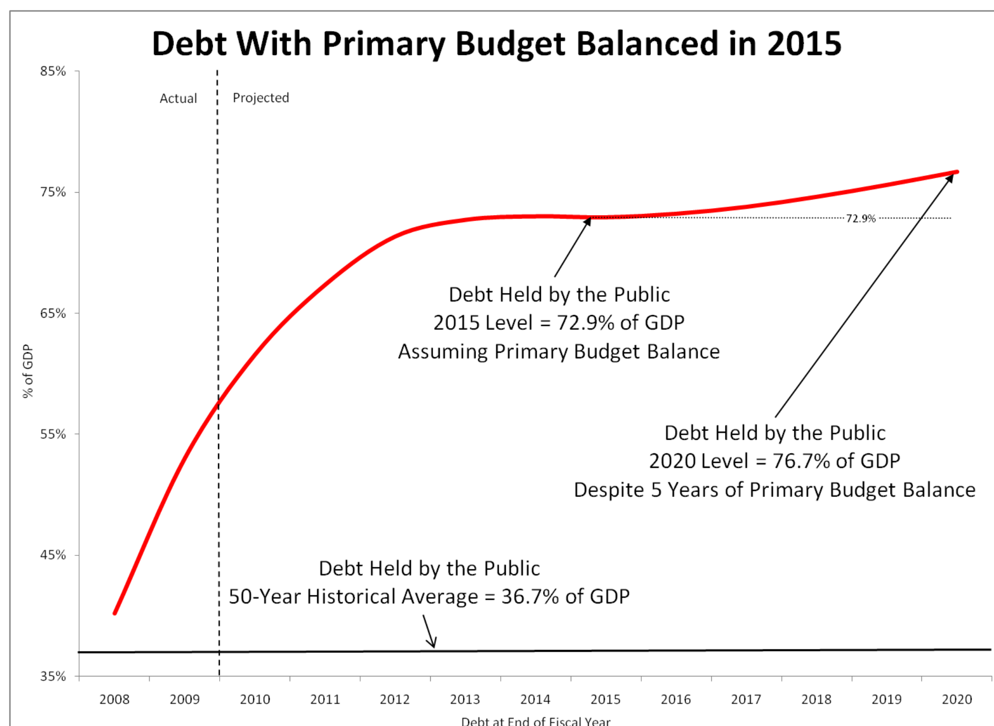
BUDGET PERSPECTIVE:
Eliminating the Primary Deficit Won't Stabilize the Debt

To prevent the Nation's debt from spiraling out of control, analysts across the spectrum recommend that the Congress and President take action to stabilize the debt as a share of the economy. Some (including the President) say that, in order to achieve this goal, we need to eliminate the "primary" deficit; that is, balance the budget, excluding interest payments on the debt.

The President created the National Commission on Fiscal Responsibility and Reform to develop a set of recommendations that would eliminate the primary deficit by 2015, which he argues would "stabilize the debt-to-GDP ratio at an acceptable level."[i] (Administration officials have also stated the goal of the Commission is to reduce the total deficit to 3 percent of Gross Domestic Product (GDP) by 2015.)

The chart below shows debt held by the public as a share of the economy, with the assumption that the primary budget is balanced (excluding interest payments) in 2015 and remains in primary balance thereafter.



The scenario above starts with the latest baseline budget outlook from the Congressional Budget Office (CBO), adjusted for certain assumptions that reflect the likelihood that Congress will not allow all laws in CBO's current-law baseline to remain unchanged.[ii] Because that adjusted "current policy" scenario would produce annual deficits higher than the "primary balance" goal set out by the President, the scenario assumes that Congress will enact other laws that guarantee that the primary budget would come in to balance beginning in 2015 and remain at that level for the following five years. But even under this scenario, the debt would not remain fixed at the level of 72.9% of GDP that it would reach in 2015. Instead, the debt would continue to rise by about four percentage points, reaching 76.7% of the economy by 2020.

Why does the debt continue to increase even if the primary budget is balanced?

In order for debt held by the public to remain constant as a share of GDP, the growth rate of the stock of debt outstanding must be equal to the rate of economic growth. But even under the assumption that the primary budget remains in balance starting in 2015, debt will still grow faster than the economy in the second half of this decade for two reasons: interest payments on the debt will increase rapidly, and the federal government must borrow money to operate government loan programs.

Under the proposals in the President's budget, the total deficit would average about 5% of GDP each year from 2015-2020, and his budget would get nowhere near achieving primary balance in 2015 and thereafter. But even if Congress were to enact laws that achieved the goal the President gave to his Fiscal Commission (primary budget balance in 2015 and after), that would only slow the rate of growth in the stock of debt outstanding (compared to the growth rate of the debt under the President's budget). To bring the growth rate of debt down to the rate of economic growth, the primary budget must be in surplus. In other words, the total deficit must be significantly smaller than a deficit that is equivalent to the level of annual net interest payments.

Interest Payments Grow Rapidly

Interest payments on the debt are expected to increase rapidly because the Treasury Department must refinance maturing debt at interest rates that are projected to be higher than recent rates. Treasury is constantly issuing new debt to replace maturing Treasury securities and to finance new deficit spending. Since the financial crisis began in 2008, federal government borrowing has been cheaper than ever in our history due to low interest rates as investors fled to the safety of US Treasury securities. Both debt rollovers and new debt incurred over the past two years were financed at these low rates.

CBO expects that interest rates in the second half of the decade will increase to levels more in keeping with historical averages. Interest rates on the 10-year note, for example, are expected to increase from 3.4 percent in 2010 to 5.9 percent from 2016 - 2020. While the Treasury issues debt securities in maturities from 30 days to 30 years, the average maturity is currently right around five years. (The average maturity has lengthened in the last 2 years as the Treasury has taken steps to lock in low interest rates never before seen.) As a result, interest costs on the debt will soon increase very rapidly, especially as new debt is issued at the higher rates to refinance debt issued during the financial crisis

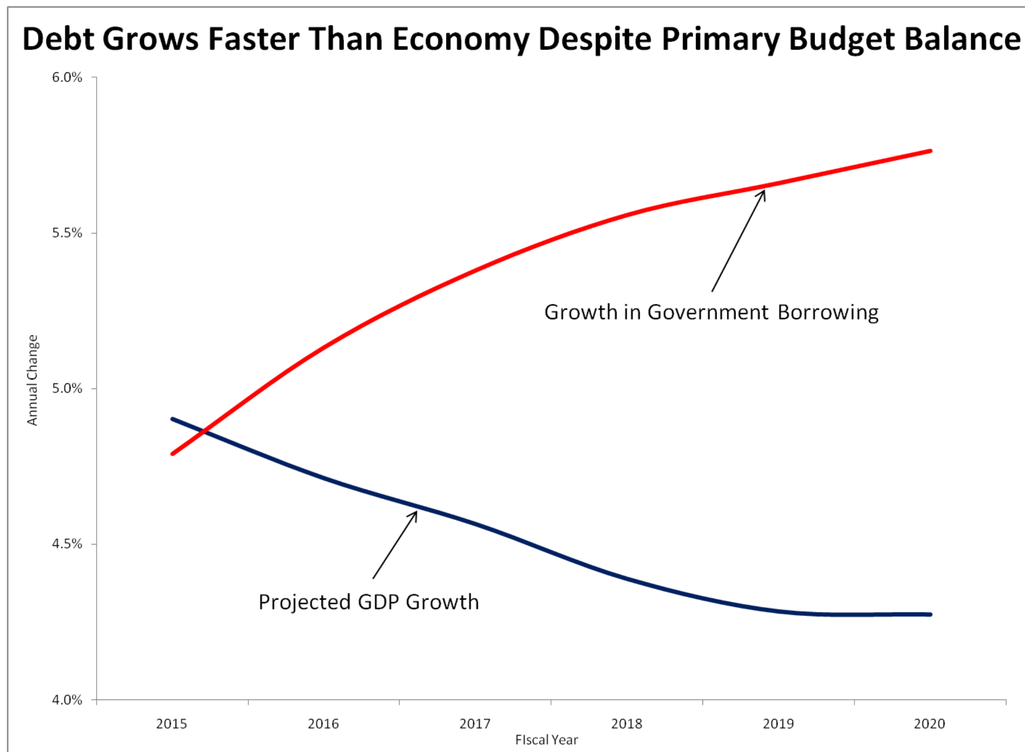
and to finance total federal deficits that will continue to occur, even if the primary budget is in balance.

More Government Borrowing Necessary to Operate Loan Progams

Besides the effects of the expected increase in interest rates (and its effect on rolled-over debt) and the new borrowing that will occur to finance future total budget deficits, future debt levels will be continue to be affected by the operation of many federal loan programs that lend directly to the public.[iii] In order for the government to get the cash to lend out, the government must borrow, and debt held by the public will increase.

As the exception to what is otherwise a cash budget, loan programs under the Federal Credit Reform Act of 1990 (FCRA) record on an accrual basis the net present value of expected losses (both direct loans and loan guarantees). The cash flows associated with each loan program are tracked in separate (means of financing) accounts. The extent to which payments out exceed payments in drives the amount of Treasury borrowing needed to operate government loan programs.

CBO's baseline projections anticipate that net borrowing needed to make loan disbursals under federal credit programs will total about $100 billion per year over the period 2016-2020. This amount increases the size of the debt above and beyond the amount needed to finance the unified budget deficit. Even under a scenario where the primary deficit is eliminated in 2015 and thereafter, the annual increase in the debt for years after 2015 would be about $100 billion per year above the amount the government would need to borrow to finance its net interest outlays.

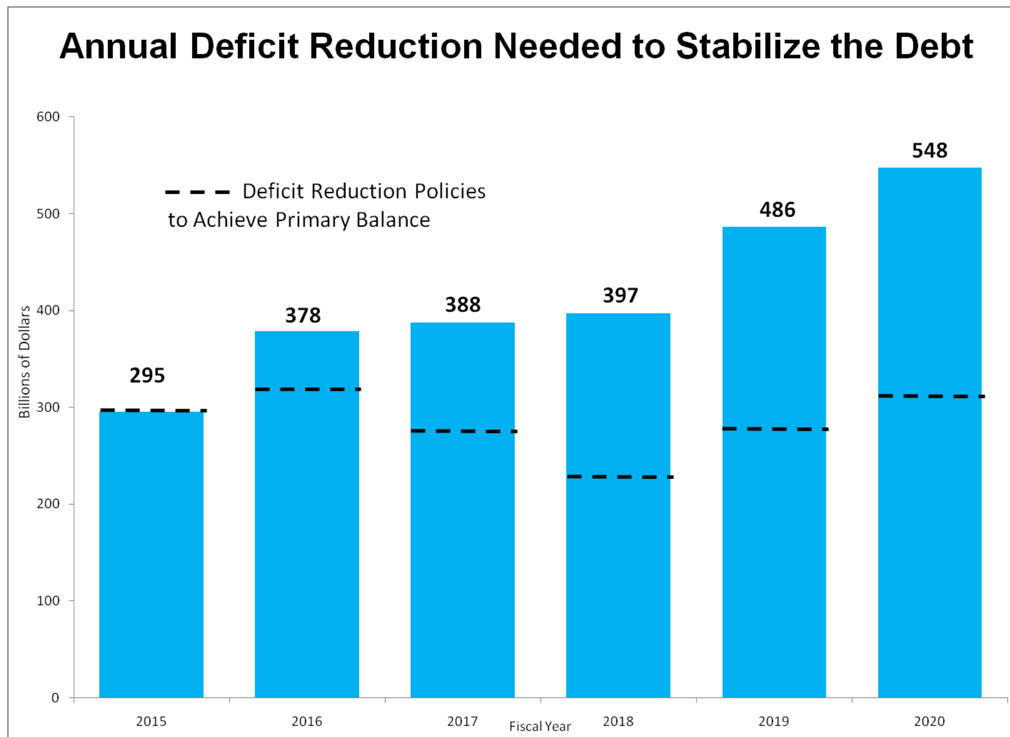


The rate of increase in the debt relative to the expected growth in the economy is shown in the graph above. Even though the primary budget deficit is expected to be zero in 2015 and thereafter if the President's goal is achieved, the growth in debt would still exceed the expected growth rate of the economy. Because debt-to-GDP is a ratio, when the numerator (debt) grows faster than the denominator (GDP), debt as a share of the economy will continue to grow – it will not remain at the level of 72.9% of GDP that it reaches in 2015.

Accordingly, eliminating the primary deficit (again, which means balancing the budget without counting interest payments) will be insufficient for maintaining the debt-to-GDP ratio constant at 72.9%. If the goal of fiscal policy is at a minimum to stabilize the debt, the deficit must be reduced to the point where the annual percentage increase in the debt held by the public is no more than the annual percentage increase in nominal GDP.

How much deficit reduction is needed to stabilize the debt?

Congress would need to take action to reduce the current policy deficit by $295 billion in 2015 to eliminate the primary budget deficit in that year. To stabilize the debt in



subsequent years at the 72.9 percent of GDP achieved in 2015, Congress would have to reduce the deficit by $378 billion in 2016, increasing to $548 billion in 2020 (relative to the current policy outlook).[iv]

The dotted lines on the bars show the amount of deficit reduction necessary to achieve primary balance; the full height of the bars show the amount of deficit reduction necessary to stabilize the debt at 72.9% of GDP. As the chart shows, substantial additional deficit reduction above achieving primary balance would be needed to stabilize the debt.

Implications of the analysis

If the goal of fiscal policy is to stabilize the debt as a share of the economy, then deficit reduction must go beyond eliminating the primary deficit. Policymakers must do more than the President called for when he established the Fiscal Commission.

The degree to which additional deficit reduction will be needed after 2015 will depend on the policy choices made to zero out the primary deficit in 2015. If policies adopted to balance the budget (excluding interest payments on the debt) in 2015 result in savings that grow rapidly after 2015, there will be less need for further policy choices.

But deficit reduction that has the effect of damping economic growth will increase the amount of savings (beyond the levels suggested above) needed after 2015 to stabilize the debt. Since maintaining a stable debt-to-GDP ratio depends on the rate of growth of GDP as well as the rate of growth in debt, actions that would cause GDP to slow relative to baseline expectations would increase the amount of additional deficit reduction needed to stabilize the debt. Spending reductions should be emphasized over tax increases that could cause GDP growth to slow.

Given the magnitude of the deficit reduction policies needed, it is likely that multiple rounds of deficit reduction will be needed to stabilize and reduce the debt.

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Appendix: Select Data on Deficits and Debt

(By fiscal year, in billions of dollars)

	2010	2015	2020
Current Policy Budget Outlook			
Total Budget Deficit	1,342	838	1,270
% of GDP	9.1%	4.5%	5.5%
Primary Budget Deficit	1,140	295	312
% of GDP	7.8%	1.6%	1.3%
Debt as a % of GDP	61.6%	74.5%	85.4%
Scenario 1: Primary Budget Balance in 2015 and Thereafter			
Total Budget Deficit	1,342	535	861
% of GDP	9.1%	2.9%	3.7%
Primary Budget Deficit	1,140	0	0
% of GDP	7.8%	0.0%	0.0%
Debt as a % of GDP	61.6%	72.9%	76.7%
Scenario 2: Hold Debt Stable as a Share of GDP at 2015 Level			
Total Budget Deficit	1,342	535	585
% of GDP	9.1%	2.9%	2.5%
Primary Budget Deficit/Surplus (-)	1,140	0	-236
% of GDP	7.8%	0.0%	-1.0%
Debt as a % of GDP	61.6%	72.9%	72.9%

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[i] Executive Order establishing the Commission dated February 18, 2010, which can be accessed at: http://www.whitehouse.gov/the-press-office/executive-order-national-commission-fiscal-responsibility-and-reform. Peter Orszag, former Director of the Office of Management and Budget (OMB), further clarifies on the OMB blog that meeting the target means that the United States would "not [be] increasing our debt relative to the size of the economy." The full post can be accessed at: http://www.whitehouse.gov/omb/blog/10/02/18/Welcoming-the-National-Commission-on-Fiscal-Responsibility-and-Reform.

[ii] Those assumptions are: (1) the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 do not expire, other than the estate and gift tax, which would continue at 2009 law per the President's request; (2) the Alternative Minimum Tax (AMT) exemption level is continued at its 2009 level, AMT brackets are indexed for inflation, and the 2009 treatment of personal credits against

the AMT is extended; (3) discretionary appropriations are at the level of the President's request, adjusted for inflation after 2015; and (4) physician payment rates in Medicare do not change from current levels.

[ii] These include the Direct Student Loan Program, Advanced Technology Vehicle Manufacturing Loans, Small Business Administration Disaster Loans, Overseas Private Investment Corporation Direct Loans, Broadband Treasury Loans, Rural Electrification Loans, and Rural Housing Insurance Fund Single-Family Housing Loans.

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[iv] The figures refer to the amount of policy changes (revenues or outlays) that would need to be enacted by the Congress. Interest savings would be in addition to the policy savings, which has been taken into account in the computations. It should be noted that these figures assume that deficit reduction policies first take effect in 2015. To the extent that any deficit reduction occurs before 2015 and reduces the debt below the level expected by the end of 2014, then Congress would not need to reduce the deficit by as much as the amounts in the graph. (It is likely, however, that such changes would be small since they would only represent the continued debt service savings on the policy changes that take effect before 2015.)