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# Separating the Debt Limit From the Deficit Problem

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Some lawmakers speak of refusing to raise the debt limit and thereby risking default on obligations of the U.S. Treasury unless Congress and the President agree to harsh spending cuts, or of raising the debt limit for only a few months at a time and thereby fostering ongoing uncertainty. To be sure, the nation's *long-term* fiscal path is unsustainable due to rising health care costs, an aging population, and inadequate revenues,[1] and policymakers should address that challenge in a balanced and timely way. But lawmakers should not hold the debt limit hostage to deficit reduction measures of their choosing or increase uncertainty and heighten the risk of default by raising the debt limit for only a few months at a time. Policymakers cannot let the government default and shouldn't create any doubt or uncertainty about that.

Some policymakers and opinion leaders confuse the issues of budget deficits, debt, and the debt limit. The deficit is the amount by which spending exceeds revenues in a particular fiscal year. The debt that matters for policy is essentially the total of federal budget deficits, minus federal budget surpluses, over the course of U.S. history. The debt limit is the legal ceiling on how much total debt the government can issue, including not just amounts borrowed in credit markets but also — oddly — Treasury securities issued to federal trust funds such as Social Security (that is, money that one part of the government lends to another). Policymakers must periodically raise that dollar cap so that the federal government can pay its bills.

Unlike any other major industrialized nation, the United States sets a legal limit on the total debt of its central government — a limit that, in its current form, dates back to World War I. To be clear, when policymakers raise the debt limit, they are merely enabling the government to pay the bills that it has already incurred through previous tax and spending policies that created deficits in the first place. Despite widespread misunderstanding, raising the debt limit does *not* create more spending or larger deficits.

Ideally, policymakers would eliminate the debt limit altogether because it serves no useful purpose and, as recent events make clear, provides opportunities for political mischief while putting the nation's financial standing at risk. But, at the very least, they should raise the debt limit in a timely way and for an extended period of time so that the government does not default or risk defaulting on its obligations, potentially causing a host of serious problems.

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[1] Congressional Budget Office, *The 2012 Long-Term Budget Outlook*, June 2012, p. 1, http://www.cbo.gov/publication/43288.

Congress' failure to raise the debt limit in a timely manner could leave the Treasury powerless to borrow money except to refinance maturing securities. That is, the Treasury would not be able to pay all of the bills that come due. The Treasury's failure to pay would amount to a first-ever federal default, which could send global markets reeling. A default would almost surely send interest rates up as our lenders demanded a greater rate of return for investing in Treasury securities. It also would likely prompt credit-rating agencies to downgrade U.S. debt, as Standard and Poor's did in the summer of 2011 in response to the last debt limit crisis.[2]

Moreover, if the Treasury can spend only what it collects in revenues, the government would have to cut spending abruptly by about 40 percent, putting an enormous drag on economic growth at a time when the economy is struggling to recover from the Great Recession. That also would harm millions of businesses, employees, and beneficiaries who rely on timely federal payments.

Treasury's options for dealing with a prolonged interruption are painful and controversial, and are sure to provoke serious legal and practical questions. History shows that even the uncertainty leading up to a debt limit increase can raise interest rates; rates rose modestly during debt-limit debates in 2002, 2003, 2010, and 2011 and during a brief "technical default" in 1979 that was due to computer glitches. Even a temporary default would jeopardize the nation's stellar credit rating and probably raise the government's borrowing costs permanently.

As Federal Reserve Chairman Ben S. Bernanke warned recently, "The threat of default in the summer of 2011 fueled economic uncertainty and badly damaged confidence, even though an agreement ultimately was reached. A failure to reach a timely agreement this time around could impose even heavier economic and financial costs...Even as fiscal policymakers address the urgent issue of longer-run fiscal sustainability, they should not ignore a second key objective: to avoid unnecessarily adding to the headwinds that are already holding back the economic recovery."[3]

Federal debt is on an unsustainable path in the long run, and policymakers need to address this challenge. But the nation does not face an immediate debt crisis, and the long-run fiscal challenge has nothing to do with the debt limit.

## Debt Determined by Spending and Tax Policies and the Economy, Not by Debt Limit

Broadly speaking, the federal government borrows money when it spends more than it collects. Congress makes the key decisions regarding how much government spends and how much it collects separately from decisions over the debt limit.

The authority to spend money on defense and non-defense discretionary programs comes through the annual appropriations process. The authority to pay for Social Security, Medicare, and other entitlement programs comes through the laws authorizing those programs, which Congress

[2] At that time, Standard and Poor's downgraded U.S. Treasury debt by one notch. Moody's and Fitch did not follow suit but have warned of possible downgrades.

[3] In a speech before the New York Economic Club on November 20, 2012 (http://www.federalreserve.gov/newsevents/speech/bernanke20121120a.htm).

periodically amends. Federal tax laws — as well as economic conditions — determine how much revenue comes in.

Before World War I, Congress generally had to approve each separate issuance of federal debt. Since then, the limit has evolved into an overall dollar cap on the amount of debt the federal government can incur. Since 1940, Congress has enacted 92 separate increases in the statutory debt limit.

On several occasions — notably in the Gramm-Rudman debates of 1985 and the "budget summit" of 1990 — the need to raise the debt ceiling may have played a role in prompting policymakers to take action aimed at reducing projected deficits. But far more often, policymakers have made decisions about raising the debt limit and reducing deficits on entirely separate tracks.[4]

It makes little sense to have a limit on federal debt that is divorced from the budgetary decisions that largely determine the amount of debt incurred. (And it makes even less sense when, as is the case, the official measure of debt subject to limit doesn't even accurately reflect the borrowing the federal government does in private credit markets; see Box 1.) In those circumstances, the mere existence of a statutory debt limit can create problems.

As the *Financial Times* editorialized, "Sane governments do not cast doubt on the pledge to honour their debts — which is why, if reason prevailed, the debt ceiling would simply be scrapped."[5] Similarly, the *Economist* has opined that "The debt ceiling in America serves no useful purpose and should be abolished."[6] Distinguished economists surveyed by the University of Chicago's business school overwhelmingly agreed that the debt ceiling "creates unneeded uncertainty and can potentially lead to worse fiscal outcomes."[7] A 1993 report by the Congressional Budget Office (CBO) explained:

> Many analysts view the statutory limit on federal debt as archaic. Through its regular budget process, the Congress already has ample opportunity to vote on overall revenues, outlays, and deficits (an opportunity that did not exist before the Congressional Budget and Impoundment Control Act of 1974). Voting separately on the debt is ineffective as a means of controlling deficits, because the decisions that necessitate borrowing are made elsewhere. By the time the debt ceiling comes up for a vote, it is too late to balk at paying the government's bills without incurring drastic consequences. In recent years, the debt limit has served mainly as a vehicle for other budgetary and unrelated legislation.[8]

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[4] Under the "Gephardt rule" that used to prevail in the House, the House raised the debt ceiling automatically each time it approved a budget resolution. The House, however, repealed that rule at the beginning of the 112th Congress, and the Senate has never had a similar rule. See Bill Heniff, Jr., "Legislative Procedures for Adjusting the Public Debt Limit: A Brief Overview," Congressional Research Service Report RS21519, November 26, 2012.

[5] "Raising the roof on America's debt," *Financial Times*, May 8, 2011.

[6] "From cliff to ceiling," The *Economist*, January 12, 2013.

[7] Chicago Booth School of Business, Initiative on Global Markets (IGM) Forum, January 15, 2013, http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_555sdN4BXmfNKCN.

[8] Congressional Budget Office, *Federal Debt and Interest Costs*, May 1993, p. 43.

## Box 1: "Debt Subject to Limit" Not a Meaningful Measure of Debt

The nation's "debt subject to limit" stood at nearly $16.4 trillion on December 31, 2012, its statutory limit. Yet most economists would say that the federal debt was only $11.6 trillion. Why the discrepancy?

Economists and investors focus *not* on "debt subject to limit" but rather on the "debt held by the public," which is the amount the government has borrowed in private credit markets to cover its cash needs. The "debt held by the public" consists of promises to repay individuals and institutions, at home and abroad, who have loaned the federal government money to finance deficits. Debt held by the public stood at $11.6 trillion on December 31.

The gross federal debt — and its close cousin, debt subject to limit — consist of debt held by the public *plus* debt that one part of the federal government owes another part. The Treasury issues special securities to Social Security, Medicare, and other federal programs whose earmarked revenues (such as from payroll taxes) have exceeded their outlays (such as for Social Security benefits). Those special securities, which totaled $4.8 trillion at the end of December, represent the assets of these programs' trust funds, which help Social Security and certain other programs withstand economic downturns and the growing pressures of an aging population. As CBO points out, "those securities represent internal transactions of the government and thus have no direct effect on credit markets."

The fact that trust fund holdings count as part of debt subject to limit has some perverse implications. Between 1998 and 2001, for example, debt subject to limit continued to grow even as the country ran budget surpluses *and retired a large amount of debt held by the public*, because Social Security was also running large surpluses and lending them to the Treasury. Similarly, in Chairman Paul Ryan's House-passed budget resolution, debt held by the public grows by about $4 trillion over the 2013-2022 period, but debt subject to limit grows by nearly $6 trillion. Acknowledging this confusion, the President's Commission on Budget Concepts in 1967 suggested that — "[s]ince the statutory public debt limit is likely to continue to be used by the Congress" — legislators consider revising its definition to exclude trust-fund holdings. To be clear, however, the existence of a debt limit, not its precise form, is the real problem; the debt limit should be abolished, not reformed.

Debt held by the public is a much more appropriate measure of federal debt, and a stable debt-to-GDP ratio is a key test of fiscal sustainability.[a] Increases in the dollar amount of debt are not a serious concern as long as the economy is growing at least as fast. Between 1946 and 1974, for example, debt held by the public grew significantly in dollar terms but — thanks to economic growth — plummeted as a share of GDP, from 109 percent to 24 percent.

Confusion about gross debt crops up in a widely cited analysis of 44 countries by University of Maryland professor Carmen M. Reinhart and Harvard professor Kenneth Rogoff, which concluded that debt-to-GDP ratios of 90 percent or more are associated with significantly slower economic growth. Their analysis, which used gross debt as its debt measure, suggested that the United States is close to that 90 percent tipping point. However, what other countries call gross debt is very similar to what we call debt held by the public; most other countries do not have the equivalent of our Social Security and other trust funds, with one part of the government lending money to another part. Federal debt held by the public is just under 73 percent of GDP now, and would rise to about 80 percent of GDP over the next decade. Stabilizing it would require further deficit reduction of approximately $1.4 trillion for the next decade.[b]

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[a] Ideally, as both the Office of Management and Budget and the Congressional Budget Office have noted, we would focus on the amount of debt held by the public minus net financial assets held by the government (such as securities and loans).

[b] James R. Horney, Kathy A. Ruffing, and Paul N. Van de Water, "Fiscal Commission Should Not Focus on Gross Debt," Center on Budget and Policy Priorities (CBPP), June 21, 2010; Richard Kogan, "To Stabilize the Debt, Policymakers

In short, the amount of debt outstanding reflects Congress's tax and spending decisions and the state of the economy, not the level of the debt ceiling. Citizens who urge their members to vote against raising the debt limit as a way of expressing displeasure with federal borrowing are picking the wrong target.

## Debt Ceiling Has Become Political Football

Because policymakers have long regarded defaulting on the country's obligations as unthinkable, raising the debt ceiling is the quintessential "must-pass" legislation.

The strange practice — which is unique to the United States[9] — of voting on the debt ceiling independently of the measures that determine federal program costs and revenues essentially makes a "no" vote costless. In 2001, the Congressional Budget Office projected budget surpluses for decades to come. The large deficits that have emerged and fueled the major increases in the debt since then — and that are projected to continue for the next decade — result primarily from the economic downturn, the tax cuts enacted during the George W. Bush administration, and fighting two wars on borrowed money.[10] Yet some members who supported those policies see no hypocrisy in voting against the resulting debt. Political division over the debt limit is not new, as the onus for passing it has traditionally fallen on the party in power.[11]

Some Republican members of Congress have expressed opposition to raising the debt ceiling (or raising it for more than a few months). In the past, influential Republicans have recognized that such brinksmanship is neither logical nor responsible. (See Box 2.)

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[9] The only other developed nation with a similar debt ceiling is Denmark, which recently raised its borrowing limit to three times the level of debt outstanding (which in the U.S., would have meant a ceiling of about $42 trillion). See John McDermott, "What the United States could learn from Denmark," FTAlphaville blog, July 26, 2011 http://ftalphaville.ft.com/2011/07/26/634961/what-the-united-states-could-learn-from-denmark/?.

[10] Kathy A. Ruffing and James R. Horney, "Downturn and Legacy of Bush Policies Drive Large Current Deficits," Center on Budget and Policy Priorities, October 10, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3849.

[11] Donald Marron, "Handicapping the Debt Limit Debate," January 14, 2011, http://dmarron.com/2011/01/14/handicapping-the-debt-limit-debate/.

### Box 2: Past Republican Statements on the Debt Limit

"This country now possesses the strongest credit in the world. The full consequences of a default — or even the serious prospect of default — by the United States are impossible to predict and awesome to contemplate."

— President Ronald Reagan, 1983

"As we fight for freedom, we must not imperil the full faith and credit of the United States Government and the soundness and strength of the American economy."

— President George W. Bush, 2002

"[O]ur government now needs to keep its promise to the American people, to all of various entitlement programs, but maybe most especially the program [Social Security] that that elderly woman asked about this morning. We must raise the statutory debt limit."

— Rep. Mike Pence (R-IN), 2002

"Raising the debt limit is about meeting the obligations we have already incurred. We must meet our obligations. Vote for this bill."

— Sen. Chuck Grassley (R-IA), 2006

## Failure to Raise Debt Ceiling Would Have Shattering Consequences

If Congress refuses to raise the debt ceiling in a timely manner, the Treasury could be unable to borrow money except to refinance maturing securities. That means it could pay out only as much as it collects in revenues — in essence, immediately balancing the budget (and not just over the course of a fiscal year, but from one week to the next).

Some scholars believe that in a debt limit crisis the Treasury can — and should — continue to borrow as usual and justify its decision on legal or constitutional grounds, or even resort to creative but exotic options like issuing a platinum coin. But if the Administration's legal experts conclude otherwise, as they seem to have, that will leave the executive branch with no alternative except deciding which bills it will pay — or, put more baldly, stiffing many legitimate creditors.

There is no precedent for such an extreme situation, and any conjectures are speculative. The few experts who have braved this area typically assume that the Treasury would opt to *issue* cash payment only for certain purposes (perhaps requiring all other creditors to accept IOUs, or "scrip"), or would pay bills in the order presented ("first in first out") depending on its available cash, requiring all other creditors to wait for steadily longer periods.[12] An alternative approach — issuing checks as usual but failing to *honor* some — is a prescription for financial and economic chaos.

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[12] Letter from Inspector General of the Department of the Treasury Eric M. Thorson to the Honorable Orrin G. Hatch, August 24, 2012, http://www.treasury.gov/about/organizational-structure/ig/Audit%20Reports%20and%20Testimonies/Debt%20Limit%20Response%20(Final%20with%20Signature).pdf.

Whichever approach the Treasury took — after weighing the staggering practical and legal issues — its task would be difficult, painful and controversial. The Treasury makes approximately 80 million separate payments each month.[13] Over the course of 2013, the government is expected to borrow slightly over one-fourth of what it spends — that is, the deficit is expected to be about 6 percent of gross domestic product (GDP), down from its recession-swollen peaks. Suddenly balancing the budget would create a sharp drag on economic growth. The economy *might* recover from such a sharp cutback in government spending — if it were brief and temporary — but the contractionary effects of a sustained deadlock, and the adverse impacts of default on financial markets, would plunge the nation back into recession and drive up unemployment.

Moreover, federal cash flows are both seasonal and lumpy. The Bipartisan Policy Center (BPC) estimates that the Treasury will run out of room sometime between February 15 and March 1. Assuming that the Treasury opted to "prioritize" (that is, make payments only for certain purposes) — and that it treated the payment of interest and principal on debt as inviolable — the BPC then sketches two unpalatable choices. (See Table 1.) In either of the two scenarios, the Treasury would be unable to pay about *40 percent* of its total obligations in timely fashion during the February 15-March 15 period.[14]

Although, under these scenarios, the government technically would not have defaulted on its debt obligations, it obviously would have dishonored many other obligations — what the Treasury Department calls "default by another name." The credit-rating agencies do not, strictly speaking, need to evaluate anything other than an issuer's ability to pay interest and principal. Yet a prolonged impasse would clearly raise doubts about the nation's creditworthiness and might well provoke a downgrade even if the Treasury prioritizes interest and principal payments.[15] Regardless of the credit agencies' actions, domestic and foreign lenders would hardly be reassured at the sight of a cash-strapped superpower picking which bills it could afford to pay.

Even on past occasions where Congress has averted an imminent default by raising the debt ceiling, uncertainty about the timing of the increase has taken a toll. The Government Accountability Office (GAO) found that interest rates rose modestly during the debt-ceiling debates of 2002, 2003, 2010, and 2011, though none of those episodes triggered an actual

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[13] Letter from Secretary of the Treasury Timothy Geithner to the Honorable John A. Boehner and other Congressional leaders, January 14, 2013. This and other Treasury materials are available at http://www.treasury.gov/initiatives/Pages/debtlimit.aspx.

[14] The BPC presented examples of both the "prioritization" and "delay" approaches. The first — giving preference to certain expenditures — is illustrated in our Table 1; the second — delaying payment until cash is available — would involve deferring payments for increasingly longer periods as the debt-ceiling interruption persisted. See Bipartisan Policy Center, "Debt Limit Analysis," January 2013, http://bipartisanpolicy.org/sites/default/files/Debt%20Limit%20Analysis%20Jan16.pdf.

[15] Fitch has explicitly warned that "prioritization" — that is, delaying payment on other obligations even while honoring interest and principal payments — would trigger a review and hence a possible downgrade. "Debt Ceiling Delay Would Prompt Formal US Rating Review," Fitch Ratings, January 15, 2013, http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=779570.

| Table 1 | | |
|---|---|---|
| **Treasury Could Not Afford To Pay All Obligations If The Debt Limit Isn't Raised** | | |
| **Scenario 1** | **If Treasury *did* pay—** | **Then it could *not* pay—** |
| | Interest on debt | Veterans' cash benefits |
| | Medicare and Medicaid | Defense vendors |
| | Social Security benefits | Federal civilian salaries |
| | Military pay and retirement | Civil service retirement |
| | Unemployment insurance benefits | SNAP, school lunch, and TANF |
| | Tax refunds for individuals | *Everything else* |
| **Scenario 2** | **If Treasury *did* pay—** | **Then it could *not* pay—** |
| | Interest on debt | Tax refunds for individuals |
| | Medicare and Medicaid | *Everything else* |
| | Social Security benefits | |
| | Military pay and retirement | |
| | Unemployment insurance benefits | |
| | Veterans' cash benefits | |
| | Defense vendors | |
| | Federal civilian salaries | |
| | Civil service retirement | |
| | SNAP, school lunch, and TANF | |
| | Department of Education grants | |

SNAP=Supplemental Nutrition Assistance Program (food stamps); TANF=Temporary Assistance for Needy Families. "Everything else" includes Supplemental Security Income (SSI) benefits, law enforcement and courts, air traffic control, disaster assistance, environmental protection and safety regulation, operation of veterans' hospitals and national parks, Head Start, and all other activities of government.

Source: Bipartisan Policy Center, "Debt Limit Analysis," January 2013. Illustrations depict hypothetical choices facing Treasury between February 15 and March 15 and are not meant to predict the government's actions.

default.[16] Also, researchers found spikes in interest rates during a brief "technical default" in April-May 1979, when computer glitches prevented the Treasury from paying certain individual investors on time.[17] The GAO estimated that higher interest rates on Treasury securities caused by the prolonged 2011 impasse cost the government $1.3 billion in that year, which the BPC extrapolated to a total of $18.9 billion over the entire period the relevant securities will be outstanding. As a large borrower, the United States can ill afford to pay higher interest rates than necessary. A sustained rise of just one basis point (i.e., one-

[16] Government Accountability Office, *Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market*, February 2011; *Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs*, June 2012.

[17] Terry Zivney and Richard Marcus, cited in Donald Marron, "The day the US defaulted on treasury bills," *Christian Science Monitor,* May 26, 2011, http://www.csmonitor.com/Business/Donald-Marron/2011/0526/The-day-the-US-defaulted-on-treasury-bills.

hundredth of a percentage point) on our almost $12 trillion in debt held by the public would cost over $1 billion a year.

## Recent Analogies to Households or to Other Countries Are Misplaced

Some policymakers and pundits have compared the debt ceiling to the limit on a household's credit card debt or on its overdraft protection. Others have likened the United States to distressed borrowers such as Greece. Both analogies are badly flawed.

Borrowers get in trouble when lenders cut off the supply of credit. Households have to retrench when a bank cuts their credit card limit because it doubts their ability to pay. Likewise, Greece and other overly indebted countries find themselves unable to borrow except at punitive interest rates. In contrast, investors both here and abroad continue to view U.S. securities as the safest in the world. Their strong demand for U.S. securities is a key reason why interest rates are so low.

To be sure, the United States needs to take significant steps to put long-term deficits and debt on a sustainable long-term path. If it does not, lenders may *eventually* stop regarding U.S. securities as one of the world's safest investments. But they will reach that judgment very quickly if the United States capriciously decides to stop paying its bills, which is what will happen if Congress refuses to raise the debt limit.

While the United States faces future budget challenges stemming from a graying population and rising health care costs, it also has one of the lowest ratios of tax revenues to GDP among developed countries. So it can — and should — raise revenues as part of any package to stabilize long-term deficits and debt.

## Conclusion

Threatening to crash the economy by refusing to raise the debt limit is irresponsible and reckless. Currently, interest rates are low, and the United States can borrow money on very favorable terms. But Congress risks creating an unnecessary crisis by shaking financial markets' faith that the United States will pay its bills on time. And Congress risks throwing the economy back into recession if some members will vote for a debt limit increase only in conjunction with sharp, immediate budget cuts.

As CBPP and others have argued, a sound goal for long-run fiscal policy would aim to stabilize debt held by the public as a share of GDP. That translates into annual federal deficits of between 2 percent and 3 percent of GDP. But because the debt would still rise in dollar terms under this scenario (though no faster than GDP), policymakers would still have to approve periodic increases in the debt ceiling. That invites a repeat of 2011's brinksmanship. Instead, it's time to jettison the useless debates over raising the government's borrowing limit and get down to the serious business of setting responsible revenue and spending policies for the long run.