CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

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REDEFINING THE DEBT CEILING POSES UNNECESSARY RISKS

by Richard Kogan

Since 1917, federal law has placed a limit on the size of the federal debt. The limit applies to gross Treasury debt — the amount the Treasury has borrowed from the public plus the amount the Treasury has borrowed from federal trust funds, such as the Social Security trust fund and the Civil Service Retirement trust fund.

Two recent proposals to alter the budget process include redefining the debt to which the debt limit applies to be the *net* debt rather than the *gross* debt, and reducing the statutory debt limit accordingly so that it is consistent with the new definition.[1] The amount that the Treasury borrows from federal trust funds would no longer be subject to the debt limit. Only the debt held by the public — the amount of money the government has borrowed from banks, states, foreign governments, and private and institutional investors — would be subject to the limit.

Looked at purely as a matter of budgetary analysis, the idea of focusing on the net debt — the debt held by the public — has merit. This measure is consistent with considering the budget as a unified whole, as most budget analysts and economists prefer. The Congressional Budget Office stresses net rather than gross debt in its budget analyses.

Nevertheless, it could be a grave mistake for Congress to place a statutory limit on the net rather than the gross debt. *If the definition of the debt subject to statutory limit becomes the net debt, as proposed, the likelihood of an unprecedented default by the federal government would be substantially increased.* Such a default would likely increase Treasury interest rates for decades to come and thereby cost the government substantial amounts (much of which would benefit foreign creditors). Since the statutory debt limit has never been a successful tool for enforcing fiscal responsibility, the proposed change in definitions would gain nothing while risking great harm.

Why the New Definition Would Risk Default

As long as the unified budget is in deficit, the net debt will rise, and there will be a periodic need to raise the debt limit. For decades, Congress has had difficulty in collecting sufficient votes to raise the debt limit. (This difficulty should not be confused with fiscal prudence; Congress frequently finds more than enough votes to cut taxes or raise program costs.) When the gross debt increases and the debt limit is reached before Congress acts to raise it, the

[1] This proposal is one (of many) included in H.R. 3800, introduced by Congressman Hensarling and about 100 others, and H.R. 3925, introduced by Congressman Kirk and about 20 cosponsors.

Treasury frequently finds it necessary to use a gimmick to avoid breaching the limit and defaulting.

The gimmick involves temporally “de-investing” a modest part of the Civil Service Retirement trust fund. This means that the Treasury borrows from the trust fund without counting that borrowing against the debt limit and without paying interest on the borrowing. The gimmick helps the Treasury continue to operate without defaulting. The gimmick harms no one — the Civil Service Retirement trust fund still has more than enough income to pay all benefits on time. And when the Congress finally raises the debt limit, the trust fund is made whole, and the lost interest is restored.

The problem with the proposed change in the definition of the debt subject to the limit is that the maneuver now used to avoid a default when Congress has not acted in time would no longer work. (Treasury would no longer be able to use the gimmick of temporarily “disinvesting” part of the Civil Service Retirement trust fund. Disinvesting means, in effect, canceling the government’s debt by declaring that the securities that have been issued are no longer valid. The Treasury can briefly disinvest the Civil Service Retirement trust fund and then make it up later. But the Treasury cannot cancel securities held by the public; doing so would itself constitute a default.) Under the new definition, if the debt limit is reached but the government continues to run a deficit, the Treasury would have no maneuvering room and would not be able to raise the cash to pay its bills. For the first time in U.S. history, government checks would bounce, and the U.S. government would default.

If a default occurred, those who deal with the United States in the future — from military contractors to those who lend to the government — would almost certainly demand higher prices because of the perception that the risk of default, previously thought to be zero, was now recognized as being higher than that. Even if the increase in interest rates on Treasury securities were as little as 10 basis points, the cost of the default would still be an extra $4 billion per year, and that amount could grow for decades. It would be a steep price to pay merely to change the terms of debate over the debt.