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SEPARATING THE DEBT LIMIT FROM THE DEFICIT PROBLEM

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Policymakers are risking a default on U.S. federal obligations because of a dispute over how to reduce budget deficits. The nation's long-term fiscal path is unsustainable, and policymakers should address it in a timely and responsible way. But policymakers should not hold the debt limit hostage to approval of deficit reduction measures that satisfy various ideological or political concerns. Policymakers cannot let the government default.

The President and Congress set budget policy through spending and tax legislation that is separate from the debt limit. Policymakers should raise the debt limit in a timely manner to avert a default while they continue to work on a long-term deficit reduction package. In addition, as part of a long-term package, they should consider eliminating the debt limit altogether because, as the events of recent weeks make clear, it creates opportunities for political mischief while putting the nation's financial standing at risk.

Congress' failure to raise the debt limit in a timely manner would leave the Treasury powerless to borrow money except to refinance maturing securities. With the power to spend only what it collects in revenues, the government would have to cut spending abruptly by over one-third, putting an enormous drag on economic growth at a time when the economy is struggling to recover from the Great Recession. It also would harm millions of businesses, employees, and beneficiaries who rely on timely federal contract, reimbursement, benefit, or other payments.

Moreover, while some lawmakers say the Treasury Department could prioritize expenditures to avoid problems after a default, Treasury Secretary Geithner says the Treasury lacks the authority to do so – and that such a step would not reassure financial markets anyway. History shows that even the uncertainty surrounding a debt limit increase can raise interest rates; rates rose modestly during debt-limit debates in 2002, 2003, and 2010 and during a brief "technical default" in 1979 that was due to computer glitches. Even a temporary default would throw away the nation's stellar credit rating and probably raise the government's borrowing costs permanently.

Federal debt is indeed on an unsustainable path in the long run, and policymakers need to squarely 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 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 91 separate increases in the statutory debt limit, an average of one every nine months (though individual increases lasted anywhere from three days to eight years).

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 galvanized policymakers to reduce projected deficits. But far more often, policymakers have made decisions about raising the debt limit and reducing deficits on entirely separate tracks.[1]

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 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* recently 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."[2] 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.[3]

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[1] In fact, 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 repealed that rule at the beginning of the current Congress. The Senate has never had a similar rule.

[2] May 8, 2011.

[3] 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 $14.3 trillion on June 30, 2011, just shy of the statutory limit (as it has since May 16). Yet most economists would say that the federal debt was only $9.7 trillion. Why the discrepancy?

Economists and investors focus *not* on debt subject to limit but rather on "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 $9.7 trillion on June 30.

The gross federal debt — and its close cousin, debt subject to limit — consists 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 Treasury special securities, which totaled $4.6 trillion at the end of June, represent the assets of these programs' trust funds, which help Social Security and some 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 Ryan's House-passed budget resolution, debt held by the public grows by about $6 trillion over the 2012-2021 period, but debt subject to limit grows by about $8 trillion. Acknowledging this longstanding confusion, the President's Commission on Budget Concepts in 1967 urged legislators to revise the statutory debt limit to count only debt held by the public, a recommendation that Congress has never addressed.

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 significant 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 dangerously 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, and debt held by the public is still well below 90 percent of GDP. CBPP estimates that debt held by the public will be 69 percent of GDP in 2011 and will reach 95 percent of GDP by 2021 under current policies. It would be 73 percent of GDP in 2021 if we let all of the Bush tax cuts expire on schedule at the end of 2012.[b]

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[a] Ideally, as both the Office of Management and Budget and the Congressional Budget Office have noted, we'd focus on the amount of debt held by the public minus net financial assets held by the government (such as securities and loans). That measure, however, is not as readily available.

[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, June 21, 2010; Kathy Ruffing and James Horney, "Economic Downturn and Bush Policies Continue to Drive Large Projected Deficits," CBPP, May 10, 2011.

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 onus for passing it has traditionally fallen on the party in power.[4]

The strange practice of voting on the debt ceiling independently of the measures that determine federal program costs and revenues essentially makes a "no" vote costless. The large deficits that fueled today's debt — and that are projected to continue for the next decade — result primarily from the economic downturn, from the tax cuts enacted during the George W. Bush administration, and from fighting two wars on borrowed money.[5] Yet some members who supported those policies see no hypocrisy in voting against the resulting debt.

Many Republican members of Congress oppose raising the debt ceiling; some publicly claim they are willing to trigger a default — which, according to the Treasury, will happen on August 2 or soon thereafter.[6] But influential Republicans in the past have recognized that such brinksmanship is illogical and irresponsible. (See Box 2.)

Failure to Raise Debt Ceiling Would Have Shattering Consequences

If Congress refuses to raise the debt ceiling in a timely manner, the Treasury will 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 day to the next).

The severe downturn from which the economy is only slowly recovering continues to depress federal revenues and swell federal outlays. For fiscal year 2011, which ends on September 30, revenues will cover about two-thirds of federal expenditures, according to CBO: the federal government is expected to spend $3.6 trillion and take in $2.2 trillion, necessitating borrowing of about $1.4 trillion (about 9 percent of gross domestic product) to finance the shortfall. If the federal government could no longer borrow, it would have to cut spending abruptly by over one-third — which would be economically disastrous if it

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

[5] Kathy A. Ruffing and James R. Horney, "Economic Downturn and Bush Policies Continue to Drive Large Projected Deficits," Center on Budget and Policy Priorities, May 10, 2011.

[6] http://www.treasury.gov/initiatives/Pages/debtlimit.aspx

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

continued for any length of time. Such cuts would put a drag on economic growth equal to 9 percent of GDP at an annual rate, in an economy that so far this year is growing at less than a 2 percent annual rate. The economy would start shrinking, and unemployment would shoot up.

Moreover, federal cash flows are both seasonal and lumpy, and August, when the Treasury will run out of options, has no major tax deadlines and is therefore an especially challenging month. The Bipartisan Policy Center (BPC) estimates that between August 3 and August 31, a prolonged inability to borrow would force the federal government to cut expenditures by *44 percent*.[7] That would affect federal employees, defense contractors, hospitals and doctors, state and local governments, farmers, colleges and universities, program beneficiaries, and millions of others. All of these people and organizations rely on timely federal payments to meet their own bills and payrolls, and an interruption would set off a domino effect of lower demand and missed payments throughout the U.S. economy.

In the event of a hiatus in federal borrowing, Senator Pat Toomey (R-PA) has called for the Treasury to prioritize certain federal expenditures, treating the payment of principal and interest as paramount. But as Treasury Secretary Geithner has explained, the Treasury lacks legal authority to do this; nor would financial markets be reassured if they saw a cash-strapped superpower picking which bills it could afford to pay today. Furthermore, the BPC

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[7] Bipartisan Policy Center, "Debt Limit Analysis," July 2011, http://www.bipartisanpolicy.org/sites/default/files/Debt%20Ceiling%20Analysis%20report.pdf.

calculations show that if the Treasury followed this approach and hoarded enough cash to pay interest during August, the cuts in other programs that month would approach *50 percent*.

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, and 2010, though none of those episodes triggered an actual default.[8] 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.[9] Mark Zandi, chief economist of Moody's, predicts that markets will become turbulent in late July if the current impasse continues.[10] 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-hundredth of a percentage point) on our $10 trillion in debt held by the public would cost $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 seriously 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 path. If it does not, lenders may eventually stop regarding the United States as a triple-A borrower. 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 federal 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.

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[8] Government Accountability Office, *Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market*, February 2011.

[9] 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.

[10] Damien Paletta, "Zandi: Markets Will Become Turbulent in July If Debt Ceiling Isn't Raised," *Wall Street Journal* "Washington Wire," June 28, 2011, http://blogs.wsj.com/washwire/2011/06/28/zandi-markets-will-become-turbulent-in-july-if-debt-ceiling-isnt-raised/.

Conclusion

As Federal Reserve Chairman Ben Bernanke stated recently, "our nation's fiscal problems are inherently long-term in nature" and we risk undercutting the still-fragile recovery if we undertake "a sharp fiscal consolidation focused on the very near term."[11] 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 creating a double-dip 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 no more than about 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 this summer'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.

[11] http://www.federalreserve.gov/newsevents/speech/bernanke20110607a.htm