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THE DEBT-LIMIT DEBATE: ADDRESSING KEY CONCERNS

While most are keenly aware of the rapidly nearing debt-limit increase deadline, few can explain—or even agree on—what that deadline means: specifically, what are the potential implications of missing the deadline, and what's at stake in the negotiations for passing an increase?

Below is a brief discussion of key questions surrounding the debt-limit debate. Mercatus Senior Research Fellows Veronique de Rugy and Jason Fichtner discuss this issue in further detail in their policy briefs "The Debt-Limit Debate" and "The Debt Ceiling: What is at Stake?"

WHAT HAPPENS IF CONGRESS MISSES THE DEBT-LIMIT 'DEADLINE'?

Q: If Congress misses the Treasury's current stated deadline of August 2, 2011 for passing a debt-limit increase, will the United States default on its debt obligations?

A: No. If Congress does not immediately raise the debt limit, the Treasury has the financial management options listed below. These would allow the Treasury to continue paying the government's obligations until the end of the fiscal year—or possibly longer.[1] To be clear, most of the options are far from desirable. They do, however, provide a means for the Treasury to continue paying the government's bills, allowing Congress and the Administration time to negotiate a debt-limit increase that includes a plan to get the nation on a sound fiscal path.[2]

> **Prioritize Payments**—The federal government is estimated to collect approximately $2.2 trillion in tax revenue in FY11.[3] While this is not enough to cover the estimated $3.7 trillion in total FY11 spending,[4] it would cover the $214 billion in estimated FY11 interest on the debt,[5] thereby preventing a technical default by the U.S. government. It also would be enough to cover Social Security ($727 billion), Medicare ($572 billion), and Medicaid ($274 billion); approximately $400 billion would remain for other priorities.[6]
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> **Take Financial Steps**—Among the "extraordinary actions" available to postpone breaching the debt limit,[7] the Treasury Secretary is authorized to declare a "debt issuance suspension period," permitting the suspension of investments in and redemption of securities held by the Civil Service Retirement and Disability Trust Fund and Federal Thrift Savings Plan. Treasury also can postpone the sale of nonmarketable debt (savings bonds, debt sold to state and local government), withdraw funds held at the Federal Reserve, and exchange Treasury securities for securities held by the Federal Financing Bank in order to use the central bank's exemption from the debt limit. The Treasury already has begun these measures.[8]
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> **Liquidate Assets**—Treasury could liquidate roughly $2.4 trillion of assets to pay government bills. Among other things, the U.S. holds $113.5 billion of non-restricted cash on hand, $315.1 billion in restricted cash and other monetary assets (gold, international monetary assets, foreign currency), and hundreds of billions in TARP assets.[9]

Raise the Debt Limit—After exhausting all of the financial options available and selling off all of the government's assets, unless spending is reduced approximately $1.5 trillion this year, the Treasury will eventually run out of options and a debt-limit increase will be necessary.

Q: How might markets react if Congress delays raising the debt limit? There is widespread concern that, even without an actual default on the nation's debt, a delay in raising the debt limit could so worry investors that they would demand higher interest rates to lend money to the U.S. government.

A: While it appears that bond investors will shrug off brinksmanship in the short run,[10] this confidence is unlikely to last if the current unsustainable level of spending continues. In fact, raising the debt limit on time—but without a serious commitment to improving the nation's fiscal path by reducing spending—would signal investors that U.S. debt is riskier than *before* Congress raised the debt limit.[11]

There are several reasons for this; key among them is the context in which this particular debt-limit debate is playing out. The U.S. is facing a debt-limit crisis—and the need for an eleventh increase in the debt limit in as many years—because chronic overspending has created an extreme fiscal imbalance, which is projected to soon grow far worse with the explosion of entitlement costs, specifically in Medicare, Social Security, and Medicaid.[12] To date, there is no plan in place to seriously address this looming crisis. Thus, the debt-limit increase agreement must serve also as a proxy budget plan and will be viewed as an indication of the U.S. government's intent to get its spending and debt under control. Concern about the U.S. fiscal situation also is intensified as parallels are drawn to the paths of European Union nations already in fiscal crisis, such as Greece.

Q: What is necessary to convince markets that U.S. debt is still a safe investment?

A: Simply raising the debt limit without recognizing and correcting systemic problems would have consequences far beyond having to resort to "extraordinary measures" to meet FY11 financial obligations. To maintain investor confidence in U.S. debt and low borrowing costs,[13] Congress must commit to real, significant, and enforceable steps to reduce spending to sustainable levels. These changes should begin immediately, and focus on institutional reforms—as opposed to one-time cuts—that direct meaningful improvement in the nation's fiscal trajectory.

Such institutional reforms could include:

Emergency Spending: Congress has increasingly abused the emergency spending designation as a giant loophole through which it can ramp up spending without it being subject to budget rules or counting toward budget-set limits.[14] Congress must put an immediate end to this and other gimmicks that thwart attempts at spending control and make an accurate accounting of the nation's current and projected fiscal status nearly impossible.

Sunset Commissions: A sunset commission would require policy makers to regularly examine a program's performance to determine whether it is still serving the purpose for which it was created, and if greater efficiency could be achieved in the delivery of services.[15]

A BRAC-like Commission for discretionary spending: Commissions composed of independent experts often can successfully tackle seemingly intractable political problems. The Base Realignment and Closure (or BRAC) Commission was successful largely because of its "silent approval" mechanism, which provided cover to Members of Congress who wanted to do the right thing but had been hindered by politics.[16]

A Constitutional Amendment to limit spending: Even if rules following the above guidelines (broad scope, few and high-hurdle escape clauses, and minimal accounting discretion) are enacted, lawmakers still have the option to change the rules as they please, and they've demonstrated in the past a propensity to do so. To solve this problem, a rule with an external enforcement mechanism, such as a constitutional amendment to limit spending, is needed.[17]

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[1] Jason Fichtner and Veronique de Rugy, "The Debt Ceiling: What is at Stake?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2011), http://mercatus.org/publication/debt-ceiling-what-stake.
[2] Ibid.
[3] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021* (Washington, DC: CBO, 2011), http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf.
[4] Ibid.
[5] Ibid.
[6] Ibid.
[7] Jason Fichtner and Veronique de Rugy, "The Debt Ceiling: What is at Stake?"
[8] Jason Fichtner and Veronique de Rugy, "The Debt-limit Debate" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, 2011), http://mercatus.org/publication/debt-limit-debate.
[9] Jason Fichtner and Veronique de Rugy, "The Debt Ceiling: What is at Stake?"; According to the Treasury Department, as of September 30, 2010, TARP had $179.2 billion in gross outstanding direct loans and equity investments valued at $142.5 billion. U.S. Department of Treasury, 2010 Financial Report of the U.S. Government.
[10] *The Wall Street Journal*, MarketBeat, **"**T-Bill Yields Plunge Toward Zero," June 23, 2011, http://blogs.wsj.com/marketbeat/2011/06/23/t-bill-yields-plunge-toward-zero/?KEYWORDS=t-bills.
[11] Joe Weisenthal, "Markets are Tanking after S&P Downgrades U.S. Debt Outlook to Negative," *Business Inside*, April 18, 2011, http://www.businessinsider.com/sp-revises-us-debt-outlook-to-negative-2011-4.
[12] Congressional Budget Office, *Long-Term Budget Outlook* (Washington, DC: CBO, 2010), http://cbo.gov/doc.cfm?index=11579.
[13] Carmen Reinhart and Kenneth Rogoff, "A Decade of Debt" (discussion paper, Centre for Economic Policy Research, London, UK, 2011), http://www.voxeu.org/sites/default/files/file/DP8310.pdf. According to economists Reinhart and Rogoff, the United States' vulnerability to interest rate changes comes in part from its failure to reduce debt levels rather than its failure to borrow more money. Historically interest rates have risen with levels of debt. While it is not unusual for interest rates to stay low in the short term even in a time of high debt, like in the United States today, at some point interest rates will increase to correspond to high debt levels. If the United States decreases its debt levels, however, the interest rates will also decline.
[14] Veronique de Rugy, "Budget Gimmicks or the Destructive Art of Creative Accounting" (Working Paper, Mercatus Center at George Mason University, 2010), http://mercatus.org/sites/default/files/publication/Budget_Gimmick_WP1030.pdf.
[15] Maurice McTigue, "It's Time to React–Reauthorizing Executive Authority to Consolidate Tasks: Establishing Results and Sunset Commissions," Testimony before the Senate Subcommittee on the Federal Workforce and Agency Organization, September 27, 2005, http://mercatus.org/sites/default/files/publication/MC_GAP_McTigueTestimony_050927.pdf.
[16] Jerry Brito, "The BRAC Model for Spending Reform," (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, 2010), http://mercatus.org/sites/default/files/publication/The%20BRAC%20Model%20for%20Spending%20Reform.pdf.
[17] David M. Primo, "Constitution is Only Way to Cut U.S. Deficit," Bloomberg.com, February 24, 2011, http://www.bloomberg.com/news/2011-02-25/constitution-is-only-way-to-cut-u-s-deficit-commentary-by-david-m-primo.htm.