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THE DEBT LIMIT DEBATE

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On Monday, May 16, 2011, the United States reached the current statutory limit on the federal government's borrowing power, the debt limit or debt ceiling, of $14.294 trillion.[1] In theory, reaching the debt limit constrains the Treasury's regular methods of financing federal activities or meeting government obligations. Treasury cannot issue new debt to manage short-term cash flows or to finance an annual deficit if such new borrowing causes the debt to exceed the statutory limit. Many fear though that Congress's immediate failure to raise the debt ceiling will rattle the bond market, drive up interest rates, and possibly lead to the United States defaulting on its debt.

While the United States should not default on its debt, neither should Congress raise the debt ceiling without addressing the problem that created the debt: excessive spending. In exchange for raising the debt ceiling, Congress should put in place a credible plan that reduces future government spending and adopts institutional reforms for the federal budget process.

A BRIEF HISTORY OF THE DEBT LIMIT

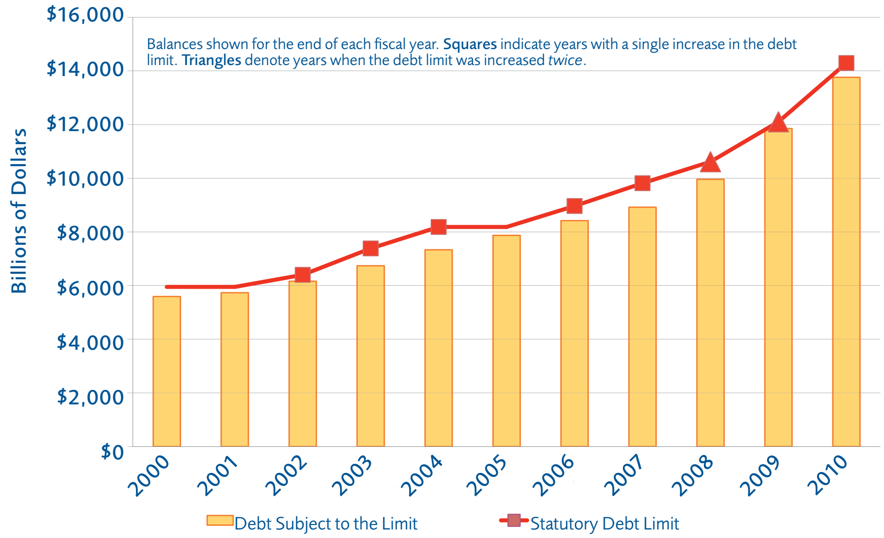
Congress first imposed a statutory limit on how much debt the federal government could issue in 1917 with the passage of the Second Liberty Bond Act, which helped finance the United States' entry into World War I.[2] By limiting the amount of debt that the federal government could accumulate, the debt limit imposed some fiscal accountability and constraints upon Congress and the Executive.

The statutory debt limit, however, has not fulfilled its purpose. Since 1917, Congress has raised the limit almost a hundred times—ten times alone in the last ten years. In some years, it has even raised it more than once (Figure 1).[3]

DEBT LIMIT CONCERNS

Two primary concerns dominate the debt limit debate: the possibility and consequences of default and rising interest rates.

FIGURE1: REACHING THE DEBT CEILING



Source: Historical Tables, Office of Managment and Budget
Produced by: Veronique de Rugy, Mercatus Center at George Mason University

Default

Given the imbalance between obligations and revenue from taxes and other sources, some commentators worry that if the debt ceiling isn't raised, a "technical default" would occur as some bondholders would not get their interest payments precisely on schedule.[4] They argue this delay in interest payments would destroy the creditworthiness of the United States, lead investors to gradually withdraw from Treasury securities, increase interest rates, and cause financial markets to seize up and impede the economy's fragile recovery. In a worst case scenario, a gradual withdrawal would turn into a stampede, causing the market to crash and the economy to go through another recession.

Treasury Secretary Timothy F. Geithner, however, has an even more expansive definition of a default. He claims delaying payment on any obligation, not just interest payments on the debt, would constitute a "default" as such delay would trigger investor concern and thus affect interest rates.[5]

Rising interest rates

Faced with a possible default, lenders would demand higher interest rates to cover the risk of lending money to the U.S. government. In such a case, the United States would have to pay these higher rates to get out from under its debt, leaving less money for other purposes.

Independent of the debt ceiling debate, higher interest rates would exacerbate the federal government's financial problems, because the United States is extremely vulnerable to interest rate threats. Unlike the mix of debt issued by most other countries, U.S. debt is mostly short-term debt. (U.S. debt overall has an average maturity of 4.4 years.[6]) With short-term debt, the borrower has to refinance the loan on regular basis, which exposes the borrower to more interest risk. When interest rates are low, the U.S. can rollover debt without a problem. However increasing interest rates would make short-term debt a greater liability.

DELAYING DEFAULT

Many federal officials insist that the only way to prevent default is to immediately raise the debt limit. If Congress delays raising the debt limit, however, the United States does not have to default on its obligations. The Treasury Department has some options that could delay this undesirable outcome for several months. That the Treasury must even consider these options highlights the irresponsible path the country is on and the need for serious institutional reform.

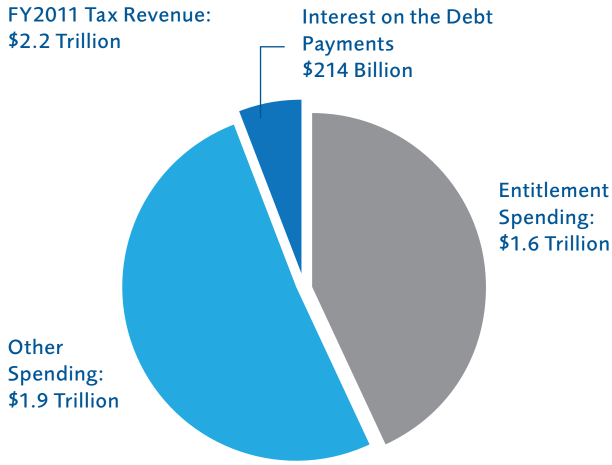
Prioritize payments

First, Treasury could prioritize payments.[7] According to the Congressional Budget Office,[8] the federal government will collect $2.2 trillion in tax revenue in FY11. Though this is not enough to cover the $3.7 trillion in total FY11 spending (Figure 2),[9] it would cover key priority areas. The $2.2 trillion would be more than enough to pay FY11 interest on the debt ($214 billion), thereby preventing a technical default by the U.S. government. It would also cover Social Security ($727 billion), Medicare ($572 billion), and Medicaid ($274 billion) expenses. After these payments, approximately $400 billion would remain for other priorities.[10]

Take Financial Steps

Second, the Treasury has several "extraordinary actions" available to postpone reaching the debt limit.[11] For instance, the Treasury Secretary is authorized to declare a "debt issu-

FIGURE 2: SPENDING BREAKDOWN



Source: Office of Management and Budget, Summary Tables

ance suspension period," which permits 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 can also 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.[12]

In fact, as Table 1 shows, using these "extraordinary actions" Secretary Geithner has managed to postpone reaching the debt ceiling from March 31 to August 2.[13]

TABLE 1: WHEN REACHING THE DEBT CEILING

DATE OF TREASURY'S LETTER	PROJECTED DATE OF REACHING THE DEBT LIMIT
1/6/2011	3/31/2011–5/16/2011[14]
3/1/2011	4/15/2011–5/31/2011[15]
4/4/2011	5/16/2011[16]
5/2/2011	8/2/2011[17]

Source: See endnotes 14–17.

Liquidate Assets

Third, once the debt ceiling is reached, Treasury would have to live off the approximately 61 cents of every dollar spent it actually receives in taxes in the current fiscal year. Alternatively, it could liquidate roughly $2.4 trillion of assets to pay government bills. Among other things, the United States holds $113.5 billion of non-restricted cash on hand,[18] $315.1 billion in restricted cash and other monetary assets (gold, international monetary assets, foreign currency),[19] and hundreds of billions in TARP assets.[20] Liquidating these assets is *not* desirable, but it could be done if necessary to provide further time for Congress and President Obama to work out a deal to raise the debt limit in exchange for future spending constraint.

Raise the Debt Ceiling

In other words, in the short term, the Treasury could sell assets to effectively manage cash flow to continue paying all of the government's bills at least through the end of the fiscal year and probably longer. After exhausting all of the financial options available and selling off all of the government's assets, unless spending is reduced approximately $1.6 trillion dollars a year, the Treasury will run out of options and a debt ceiling increase will be necessary. The question is when.

THE REAL SOLUTION: CUT SPENDING

The United States is facing a debt limit crisis, because the United States spends too much money. The past ten years of unprecedented government spending has created an extreme fiscal imbalance,[21] which is projected to get worse with the explosion of entitlement programs such as Social Security, Medicare and Medicaid.[22] Regardless of whether Congress raises the debt ceiling, the United States must put its fiscal house in order and reduce government spending.

Reducing spending would not only provide funds with which to start reducing the debt, but it would also maintain the United States' low borrowing costs.[23] Raising the debt ceiling without a serious commitment to changing the fiscal path of the country, however, *will* signal investors that Treasury debt is riskier that it was before Congress raised the debt ceiling.[24] While bond investors seem to shrug off brinksmanship in the short run, they likely won't in the long.

Thus, in addition to putting forth a plan to reduce future spending, Congress must enforce any agreed upon spending reductions by placing institutional reforms on the federal budget process. Such reforms could include adopting a constitutional amendment to limit spending, implementing meaningful budget reforms that limit lawmakers' tendencies to spend, such as a strict CUT-AS-YOU-GO system,[25] or imposing mandatory, annual real spending caps.[26]

CONCLUSION

The debt crisis emphasizes the United States' urgent need for institutional spending reform. The good news is that the U.S. has enough expected cash flow (tax revenue) and assets on hand to avoid unattractive options such as default on obligations until the end of the current fiscal year in September, perhaps longer. This gives Congress and the administration time to work out a deal to raise the debt limit along with reducing spending and instituting reforms that would shrink the deficit and get the nation's spending and debt under control.

ENDNOTES

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18. Daily Treasury Statement, April 19, 2011, https://www.fms.treas.gov/fmsweb/viewDTSFiles?dir=w&fname=11041900.pdf.

19. U.S. Department of Treasury, *2010 Financial Report of the U.S. Government* (Washington, DC: GPO, 2010), 6, http://www.gao.gov/financial/fy2010/10frusg.pdf. The Treasury owns approximately 264.3 million ounces of gold and marks the value of its gold holdings at $42 per ounce, giving a reported value of $11.1 billion. At a spot market price of $1,500 per ounce, Treasury's gold holdings could be valued near $400 billion.

20. 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*.

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23. 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. 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.

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