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## The Better Budget Process Initiative:

# Improving the Debt Limit

March 13, 2015

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## Introduction

The debt ceiling was first created in 1917 and established in its current form around 1940. Prior to that, Congress had to approve each issuance of debt, whereas the new ceiling allowed debt to be issued regularly as long as it stayed below a nominal limit. Because spending has generally exceeded revenue collection causing the government to borrow each year, the country has regularly bumped up against the debt limit. As a result, the debt limit has been increased, extended, or suspended a total of 92 times.

A number of these increases, in the past, have been used as an opportunity to address our growing national debt or enact fiscal reforms (see chart below). As one of the only "fiscal speed bumps" in the budget process, it has served the purpose of helping to focus Washington's attention on our fiscal situation.

Yet the debt limit has also led to brinksmanship, ad hoc last minute negotiations, and risk of default. If the U.S. were to default on its obligations, severe consequences could reverberate throughout the global economy. Even the threat of default can contribute to economic weakness and instability.[1]

Because a potential default comes with such grave consequences, and with the debt remains on an unsustainable path, we recommend reforming the debt ceiling to attempt to balance both the need to build into the budget process triggers to push lawmakers to confront the question of whether their borrowing is sustainable and to avoid damaging and costly debt ceiling showdowns. Reform options fall into four basic categories:

- **Link changes in the debt limit to achieving responsible fiscal targets**
- **Incorporate the debt limit into Congress's fiscal decision making**
- **Apply debt limit to more economically meaningful measures**
- **Replace the debt limit with limit on future obligation**

1 One option which might be available if the debt limit were breached would be to "prioritize" interest payments. However, the Treasury Department has indicated it does not have the technical capability to do so at this point, and more importantly a failure of the U.S. to pay its non-interest obligations might also be viewed as a "default" or otherwise call into question the full faith and credit of the U.S. government. http://www.treasury.gov/connect/blog/Pages/Report-on-Macroeconomic-Effect-of-Debt-Ceiling-Brinkmanship.aspx

# How to Refocus the Debt Limit

If the goal is to promote fiscal responsibility, the current debt limit is perhaps too blunt and too dangerous a tool. The current process for dealing with the limit lacks any direct ties to spending and tax decisions or fiscal goals; it places no restrictions on the tax and spending decisions that lead to our levels of debt (ultimately leaving no choice but to raise it); it focuses on past decisions rather than current and future ones; it measures debt in gross nominal dollars, rather than the net percent of Gross Domestic Product (GDP) measures which most economists prefer; and while it does provide an incentive to act, the cost of failure is simply too high.

Perhaps the best answer is not to repeal the federal debt limit, but to reform the process for addressing it. Reforming the debt limit requires simultaneously balancing a number of goals. Importantly, most reforms will not be able to simultaneously achieve all of these goals, and certainly not give the same weight to each of them, so policymakers will need to prioritize their importance. In general, though, a reformed process for dealing with the debt limit should:

- Balance the needs to encourage fiscal responsibility and reduce the risk of default
- Encourage changes that improve the fiscal health of the country
- Establish an orderly process for dealing with debt limit in advance of deadlines
- Link action on the debt limit to fiscal policy goals or tax and spending decisions
- Focus on limiting future incurred liabilities rather than calling into question whether past obligations will be honored

## Summary of Debt Limit Reform Options:

***Link changes in the debt limit to achieving responsible fiscal targets***

1) Presidential authority to increase the debt limit if fiscal targets are met
2) Presidential authority to increase the debt limit if accompanied by a plan to put debt on a declining path as a share of GDP
3) Suspend the debt limit automatically if fiscal targets are met

***Incorporate the debt limit into Congress's fiscal decision making***

4) Automatically increase the debt limit upon passage of budget resolution
5) Require reconciliation instructions to increase the debt limit to accommodate debt levels in the budget resolution
6) Require legislation with significant net costs to include an increase in the debt limit

***Apply the debt limit to more economically meaningful measures***

7) Subject debt held by public instead of gross debt to the debt limit
8) Index the debt limit to GDP growth, effectively capping debt-to-GDP

***Replace the debt limit with limit on future obligations***

9) Apply the debt limit to future liabilities and unfunded obligations
10) Replace the debt limit with a "debt cap"

## Debt Ceiling Increases and Fiscal Reform

Although policymakers have often enacted "clean" debt limit increases, Congress has coupled debt limit increases with other legislative changes on many occasions. In a number of cases, Congress has attached debt ceiling increases to budget reconciliation legislation and other deficit-reduction policies or processes.

In fact, most of the major deficit-reduction agreements made since 1980 have been accompanied by a debt ceiling increase.

Causality has moved in both directions, though. On some occasions, the debt limit has been used successfully to help prompt deficit reduction, and in other instances, Congress has tacked on debt ceiling increases to deficit-reduction efforts.

| Act Containing a Debt-Limit Increase | Component | |
|---|---|---|
| | Budget Process Reforms | Major Deficit Reduction |
| Gramm-Rudman-Hollings Act of 1985 | X | |
| Omnibus Budget Reconciliation Act of 1990 (including the BEA of 1990) | X | X |
| Deficit Reduction Act of 1993 | | X |
| Balanced Budget Act of 1997 | | X |
| Statutory PAYGO Act of 2010 | X | |
| Budget Control Act of 2011 | X | X |

More discussion of some of these instances can be found here.

# Options for Reforming the Debt Ceiling

The options outlined in this paper are not an exhaustive list of possible modifications, but represent an effort to outline ways the debt limit can be improved to address concerns about legislative brinksmanship and threat of default, while maintaining a tool to encouraging fiscal discipline. The options are generally not mutually exclusive, and can be combined, adjusted, or modified in a number of ways.

### Link Changes in the Debt Limit to Achieving Responsible Fiscal Targets

The need for regular legislative action to increase the debt limit is an unpleasant process for the executive and legislative branch, which has led to considerable interest in reducing or eliminating the need for legislative action to raise the debt limit. Such a change would certainly reduce brinksmanship surrounding debt limit increases, but it would also neuter the ability of the debt limit to encourage fiscally responsible behavior. Linking a mechanism making it easier to raise the debt limit to achieving responsible fiscal targets could give the President and the Congress a powerful incentive to enact and retain fiscally responsible policies.

Several proposals have been put forward to allow Congress to avoid the need for an affirmative vote to approve an increase in the debt limit by codifying the so-called "McConnell rule" which allows the President to increase or suspend the debt limit subject to Congressional disapproval. This effectively allows an increase or suspension of

the debt limit with the support of just the one-third plus one members in one chamber necessary to sustain a Presidential veto, and thus reduces threats of default. However, it effectively eliminates the role of the debt limit as a “fiscal speed bump” that encourages an examination of fiscal policy.

***1) Presidential authority to suspend the debt limit if certain fiscal targets are met***

One option would be to pass a modified version of the “McConnell rule” which made its availability conditional on taking fiscally responsible actions. Specifically, Presidential authority to increase or suspend the debt ceiling could be granted only if the ratio of debt held by the public to GDP was below a specified target – or alternatively, was projected to be below a certain target at some point in the future under current law. This would give the President and Congress an incentive to put in place policies necessary to meet fiscal targets and follow through with any actions necessary to keep the budget on course to meet the targets in order to avoid the politically difficult process of passing an increase in the debt limit. But unlike the current approach in which debates about enacting policies to control the debt occur when debt is approaching the limit as a result of debt that has already been incurred, this approach would create an incentive to act on fiscally responsible policies before debt is incurred in order to meet the targets.

For example, the President could be granted the authority to suspend the debt limit for the upcoming year if the debt held by the public at the end of the fiscal year were equal to or lower than the prior year as a percentage of GDP. As with the McConnell rule, the President’s debt limit increase would be subject to Congressional disapproval, meaning there would be an automatic vote on a resolution disapproving of the increase in the debt limit which the President

This change would reward fiscally responsible behavior and results. At the same time, under this scenario, increasing the debt limit if the debt target was not met would be no more difficult than it is under current law. Congress and the President would then need to negotiate and vote on a legislative debt ceiling increase as they do today. In this sense, the conditional suspension authority would allow the debt limit to serve as an incentive for fiscal responsibility.

***2) Presidential authority to increase the debt limit if accompanied by policies to stabilize debt***

An alternative approach would be to allow the President to increase the debt limit (subject to Congressional disapproval) if the budget included policies sufficient to put the debt on a declining path as a percentage of GDP in the upcoming fiscal year and subsequent fiscal years. Under this approach, the President could increase the debt limit by an amount sufficient to accommodate increased debt in the next fiscal year under the President’s budget If Congress failed to enact the President’s deficit reduction policies or alternative policies to put the debt on a declining path, the debt would increase in the next fiscal year by more than the increase in the debt limit authorized by the President. In that event, the President would need to request and would Congress required to enact an increase in the debt limit before the end of the fiscal year.

This approach has some similarities to the policy in New Zealand, where the government is supposed to maintain debt at a “prudent level” and set specific targets for meeting that goal. If the debt deviates from these targets, the Minister of Finance must explain how the government intends to take to return to the “prudent levels.

***3) Suspend the statutory limit on debt if long term debt targets are met***

Rather than give the President discretionary authority to increase the debt limit, another approach would be to establish an automatic suspension of the debt limit if certain fiscal metrics were met. This could be based on current debt levels as a share of GDP, future projected debt, solvency of entitlement trust funds, total unfunded liabilities, or other measures of fiscal responsibility. As with the Presidential authority to suspend the debt limit discussed above, this would be a new mechanism to avoid the need for legislation increasing the debt limit and would not make it harder to enact increases in the debt limit than it is today if the targets are not met.

Policymakers could preempt the need to enact an increase in the debt limit in the future by enacting fiscal policies which would meet the targets for suspending the debt limit. However, this approach could face implementation challenges in determining what targets should be met, who is responsible for determining if the targets are met, and what assumptions should be used in making the determinations.

## Incorporate the Debt Limit into Congress's Fiscal Decision Making

The current debt limit leads policymakers to recognize increases in debt after they legislate them rather than when the borrowing is authorized. This allows policymakers to pass deficit-increasing tax cuts and spending increases one day, and then complain about increasing the debt limit to accommodate the resulting debt the next. Instead, increasing in the debt limit could be linked to decisions on tax and spending policies which actually result in increases in debt.

***4) Automatically approve increase in debt limit upon passage of budget resolution***

With a functioning budget process, the simplest way to link the debt limit to decisions of future debt levels would be to reinstate a version of the "Gephardt rule" (see box on page X) providing that when Congress adopts a budget resolution, spin-off legislation providing for a debt limit increase is deemed to have passed as well. This increase should be set equal to debt under the budget the budget at the end of the fiscal year so that the final increase in the debt limit enacted into law reflects the level of debt assumed in the budget resolution consistent with the spending and revenue policies in the budget.

This change could strengthen the budget process in several ways. First, it would create an incentive to adopt a budget conference report by allowing Congress to avoid a debt limit vote if they did so. Second, it would require Members of Congress to acknowledge the level of debt resulting from the policies assumed in the budget resolution, and hopefully encourage members to therefore pursue lower deficit levels. Third, it would encourage Congress to abide by the spending and revenue levels in the budget and implement any deficit reduction assumed in the resolution in order to avoid the need for further action increasing the debt limit again. If Congress failed to enforce the budget resolution and as a result the debt increased by more than the amount assumed in the budget, Congress would need to enact separate legislation increasing

### History of the Gephardt Rule

The House of Representatives adopted the Gephardt Rule, named after its sponsor, Representative Richard Gephardt (D-MI) in 1979 in an effort to avoid separate votes on debt-limit legislation by deeming passage of a separate "spin-off" bill increasing the debt limit upon adoption of a budget resolution conference report.

The Gephardt Rule required the House Clerk to automatically engross and transmit to the Senate, upon the adoption of a conference agreement on the budget resolution, a joint resolution changing the statutory limit on the public debt by the amount recommended in the budget resolution. The joint resolution was deemed to have passed the House by the same vote as the conference report on the budget resolution. The joint resolution was then transmitted to the Senate, where it was considered (or not) like any other legislation approved by the House. The Senate has never had a procedure similar to the Gephardt Rule. Instead, it relies on the regular order or the reconciliation process to consider debt-limit increases.

There was mixed success of the rule leading to enactment of increases in the debt limit. On some occasions the Senate passed the joint resolution transmitted by the House under the Gephardt rule, usually right before the deadline for action on a debt limit. On other occasions, the Senate amended the joint resolution from the House by changing the level of debt or adding other policy provisions, and sent it back to the House for a separate vote. In other instances the Senate ignored the joint resolution sent over from the House and legislation increasing the debt limit was considered under regular legislative process.

The Gephardt rule was repealed in the 107th Congress, restored in the 108th, and then repealed again at the beginning of the 112th Congress in 2011.

the debt limit, which would highlight the failure of Congress to abide by the budget. And finally, it would provide greater certainty and stability in debt management by approving necessary debt limit increases well in advance of when the ceiling would be hit.

Unlike the original Gephardt rule which only applied to the House, a reinstated rule could apply to both the House and Senate. This can be achieved by providing that the spin-off debt limit legislation sent over by the House would be deemed to have been passed by the Senate upon approval of the budget resolution conference report in the Senate.

A number of other modifications could also be made to the Gephardt rule. For example a reinstated Gephardt rule could be structured to encourage fiscally responsible budgets by making the spin-off process conditional on the budget resolution meeting certain debt targets such as requiring the budget resolution to propose debt levels that are stable or declining as a percentage of GDP in order to trigger approval of a debt limit increase.

As another example, policymakers could address the critique that the Gephardt rule reduces accountability for increases in the debt by replacing the "deeming" with an automatic an immediate vote on separate debt limit increase upon passage of a budget resolution. Of course, under this approach there would be the risk that members who voted for the budget resolution would then vote against legislation increasing the debt limit by the amount assumed in the budget resolution, which would undercut the goal of increasing accountability between budget decisions and the debt limit.

***5) Require reconciliation instructions to increase the debt limit to accommodate debt levels in the budget resolution***

As an alternative to linking debt limit increases directly to the budget resolution, the budget resolution could be required to include reconciliation instructions for an increase in the debt limit consistent with the debt levels in the budget. Budget resolutions rely on reconciliation to require congressional committees to make changes to laws in their jurisdiction to comply with the assumptions in the budget resolution, including changes in laws regarding entitlement programs and taxes to bring spending and revenues within the levels assumed in the budget. Reconciliation also can be used to increase the debt limit, but is not used for this purpose very often. Legislation passed through reconciliation moves under an expedited legislative process that is not subject to filibuster and therefore does not require 60 votes in the Senate.

The law could be changed to *require* the budget resolution include reconciliation instructions to increase the debt limit. Since reconciliation is currently mainly used as a tool for deficit reduction, this change could also at least help to encourage deficit reducing policies are enacted alongside the debt limit increase.

Similar to the options to reinstate the Gephardt rule, this requirement would commit Members who voted for a budget resolution to a vote on legislation increasing the debt limit by the amount the debt would increase in debt under the tax and spending policies assumed in the budget (though Members could vote for the budget resolution and against reconciliation bill increasing debt limit consistent with the budget resolution).

And because a budget resolution could also include reconciliation instructions requiring savings for deficit reduction, it could also provide a formal mechanism for consideration of deficit reduction legislation to accompany increases in the debt limit through the regular budget process instead of doing so on an ad hoc basis.

***6) Require legislation with significant costs to include an increase in the debt limit***

In addition to or instead of linking debt limit increases to debt increases from a proposed budget, increases in the debt limit could be tied to actual debt-increasing legislation. Specifically, lawmakers could be required to accompany legislation increasing net deficits with an increase in the debt limit equal to the projected deficit increase from the legislation.

Congress has adopted this practice informally on a few occasions, including legislation providing authority for federal takeover of Fannie Mae and Freddie Mac, the Troubled Assets Relief Program (TARP) and American Recovery and Reinvestment Act (2009 stimulus). Each of these pieces of legislation would have increased the debt, and each was accompanied by a debt limit increase to accommodate that new debt.

Importantly, increases in the debt limit accompanying deficit increasing legislation would only represent a small portion of the increase in debt subject to limit, since the bulk of the increases in debt are due to structural imbalances between spending and revenues in current law and not new legislation passed by Congress. Nonetheless it would provide greater accountability in the legislative process by requiring policymakers to explicitly acknowledge the increase in debt when they vote for legislation which would increase the debt.

## Apply the Debt Limit to More Economically Meaningful Measures

The current statutory limit essentially applies to total gross debt with a few minor exceptions. Gross debt has two main components: debt held by the public and debt held by government accounts. Most economists believe the debt held by the public to be a significant measure of debt, but debt held in government accounts more an accounting measure than representation of federal borrowing. The current debt limit is also set on a nominal basis which is not adjusted for inflation nor the country's ability to bear that debt. Most economists prefer to measure debt as a share of GDP.

### *7) Subject debt held by public instead of gross debt to the debt limit*

Modifying the debt limit to apply only to debt held by the public would bring the debt limit in line with measures of debt used by economists to judge outstanding debt levels. Debt held by the public reflects the cumulative amount of government borrowing from the private sector and other countries to cover the shortfall between total government revenues and spending. It provides a more meaningful indication of the impact of government borrowing on the economy. An increase in debt held by the public represents an increase in total government indebtedness.

The level of the gross federal debt (and therefore the debt subject to limit) can increase for two very different reasons: (1) the need for the federal government to increase its borrowing from the public in order to finance its operations in the face of insufficient revenues; and (2) the existence of trust fund surpluses that must be invested in government securities. It is therefore possible for the gross debt to grow when the federal budget is balanced or even running a surplus. Because the debt limit applies to debt held by government accounts as well as debt held by the public, the need to increase the debt limit does not necessarily provide a meaningful indication of fiscal health.

Applying the debt limit to debt held by the public would mean applying it to a more economically meaningful measure of federal borrowing. On the other hand, gross debt provides a greater (though still incomplete) measure of our current obligations and would move in the opposite direction of limiting obligations as opposed to outstanding debt if that is the approach policymakers prefer.

### *8) Index the debt limit to GDP growth, effectively capping debt-to-GDP*

Another way to link the debt limit to important measures of fiscal health would be to tie it to debt held by the public relative to GDP. The current debt level is set at a nominal level that remains fixed without regard for inflation or growth in the economy. Economists prefer to measure debt as a percentage of GDP because the amount of debt we can sustain increases as the size of GDP increases. That measure indicates whether the government's participation in credit markets is expected to grow faster or slower than economic output and provides a useful guide about whether a given level of debt is economically sustainable. As a general rule, debt is considered to be sustainable if debt is stable or declining as a percentage of GDP. It is possible for the nominal amount of debt to grow, requiring an increase in the debt limit, even if debt is stable or declining as a percentage of GDP.

If ones goal is to prevent growth of debt to GDP as opposed to nominal debt, it would make more sense for the debt limit itself to apply to the debt-to-GDP ratio. As a practical matter, this could be achieved by automatically indexing the nominal debt ceiling to the growth in GDP on an annual or semi-annual basis.

This change would prevent debt from rising as a share of GDP without legislation, and in doing so would make a legislated increase the debt limit a more meaningful indication of fiscal stewardship (or lack thereof), because it would only be necessary to enact an increase in the debt limit if policymakers have failed to keep the debt on a stable or declining path.

Of course, indexing debt limit at current levels would allow for debt levels that are higher than any time in history other than around World War II. It

would therefore be prudent to make implementation of a policy indexing the debt limit contingent upon the debt falling below a specified threshold as a percentage of GDP or for policymakers to enact a plan to put debt on a clear downward path and provide for indexation of the debt limit when it is at a more sustainable level.

Importantly, while the two policy changes described above could be enacted separately, they would be most effective if enacted in concert. Effectively changing the debt limit to cap debt held by the public as a share of GDP would ensure it applies to the most meaningful measure of the fiscal health of the country.

## Replace the Debt Limit with Limit on Future Obligations

One problem with the debt limit is that it applies only to debts already incurred. By the time policymakers consider an increase in the debt limit, it is generally already too late to make any changes to avoid hitting it, leaving them no other choice but to increase or suspend that limit. The debt limit does not reflect future liabilities or obligations, which actually could be changed and will affect the fiscal position of the government. Nor does the debt limit include an enforcement mechanism that would reduce future debt.

***9) Apply the debt limit to future liabilities***

The current debt limit only applies to debt that the government has already incurred and not to commitments the government has made for the future. Accounting for future obligations in the debt limit would provide a more complete assessment of the government's overall financial condition. This could be done by capping the net liabilities of the federal government and net social insurance liabilities in excess of revenues estimated in the Treasury Department's Financial Statement – about $59 trillion as of fiscal year 2014.

In addition to providing a more complete picture of the U.S. government's fiscal condition, applying the debt limit to future liabilities as well as outstanding debt held by the public would allow policymakers to respond to a warning that the limit was about to be reached by enacting policies reducing future liabilities (for example, through long-term entitlement reform) to avoid the need to increase the limit. In this way, the debt limit would serve as a tool to encourage fiscally responsible policies in a way that the current limit does not.

Of course, implementing a limit on total net liabilities would involve many practical challenges. Projections of future liabilities are highly dependent upon underlying assumptions, with different entities producing very different estimates. The magnitude of net liabilities and amount of annual change in liabilities can vary significantly based on minor changes in underlying assumptions. In addition, Congress could avoid breeching the limit by enacting legislation providing for a significant reduction in entitlement benefits that would not take effect until twenty five years later, with no expectation that those reductions would be allowed to take effect. In addition, net liabilities of social insurance programs includes costs of promised benefits after trust fund reserves used to fund those programs are exhausted and the programs are not able to provide full benefits and therefore do not represent legal obligations.

Finally, even if the limit applied to total net obligations, the practical effect of the limit would be on the ability of Treasury to issue new debt securities to finance government debt on a daily basis. Calculating the future liabilities of the government is a lengthy process that could not be updated on a real time basis. As a practical matter a limit on total net liabilities would likely need to apply to a hybrid of actual debt outstanding at any given point in time and the most recent estimate of outstanding liabilities.

***10) Replace the debt limit with a "debt cap"***

Instead of basing the debt limit on future obligations, policymakers could simply enforce it with reductions in future debt (currently, it is enforced by prohibiting any further borrowing). One approach to do this would be to replace the statutory debt limit with a "debt cap" that requires Congress and the President to enact policies to ensure the debt-to-GDP ratio is within specified targets, enforced by automatic spending cuts and revenue increases if Congress and the President fail to act.

The debt cap could apply to the upcoming fiscal year, or to a rolling five year period. The latter approach would allow Congress and the President to enact policies that gradually reduce debt below

the cap by the end of the five year period. As similar policy exists in Switzerland where a statutory debt brake limits spending growth to the average revenue increases over a multiyear period. This ensures on average spending won't grow fast than revenue.

Under a debt cap, the President's budgets and Congressional budget resolutions would be required to propose policies for the upcoming fiscal year that would result in debt being below the target percentage of GDP. If the debt was projected to exceed the debt cap for the upcoming fiscal year under current law, the President would be required to submit legislation making changes in spending programs and tax laws to bring debt within the debt cap. Congress could then be required to consider the President's recommendations or alternative policies bringing debt within the cap under a fast-track process.

If legislation bringing projected debt within the cap was not enacted by the beginning of the fiscal year, automatic across-the-board spending cuts and tax expenditure cuts or tax increases would go into effect. Special rules could also be put in place to suspend the cap during economic downturns to prevent extreme austerity during a recovery.

# Conclusion

Though the statutory debt limit has often focused Washington's attention on the national debt, it has sometimes done so at too high a cost. Congress must raise the debt ceiling as debt continues to accrue, but they also must continue the much more difficult task on putting debt on a downward path relative to the size of the economy. While the brinksmanship surrounding the debt limit in recent years has created unnecessary risk and economic harm, the debt limit can be a useful tool for focusing attention on our fiscal condition and encouraging action to improve our fiscal outlook.

There are numerous options for reforming the debt limit which reduce the risk of a default while providing both carrots and sticks to encourage fiscal responsibility and providing greater accountability in the budget process. Reforms of the debt limit could also make the debt limit a more meaningful measure of our fiscal condition and create a greater link between the debt limit and the policy decisions affecting the debt.