Committee for a Responsible Federal Budget

Raising the Debt Ceiling
January 21, 2010

Congress raised the debt ceiling by $290 billion in December 2009 – enough to fund government operations through mid-February. Yesterday the Senate began discussion of legislation to raise the nation's debt ceiling further. The Senate is considering legislation passed by the House in April 2009 raising the limit to $13 trillion. Senate Majority Leader Harry Reid has proposed an amendment raising it instead by $1.9 trillion to $14.3 trillion, in order to sustain government operations through the 2010 elections. The final vote to raise the debt ceiling will require 60 votes to pass, due to an agreement struck between party leaders last December.

The Senate is expected to consider a number of amendments with the debt ceiling increase, including several designed to improve the nation's fiscal situation. Three amendments in particular seem promising steps towards greater fiscal control and responsibility. These include a deficit commission proposed by Senators Conrad and Gregg, a pay-as-you-go amendment from Senator Reid (although we are concerned about any exemptions which may be included), and an amendment proposing discretionary spending caps from Senator Sessions.

History and Background

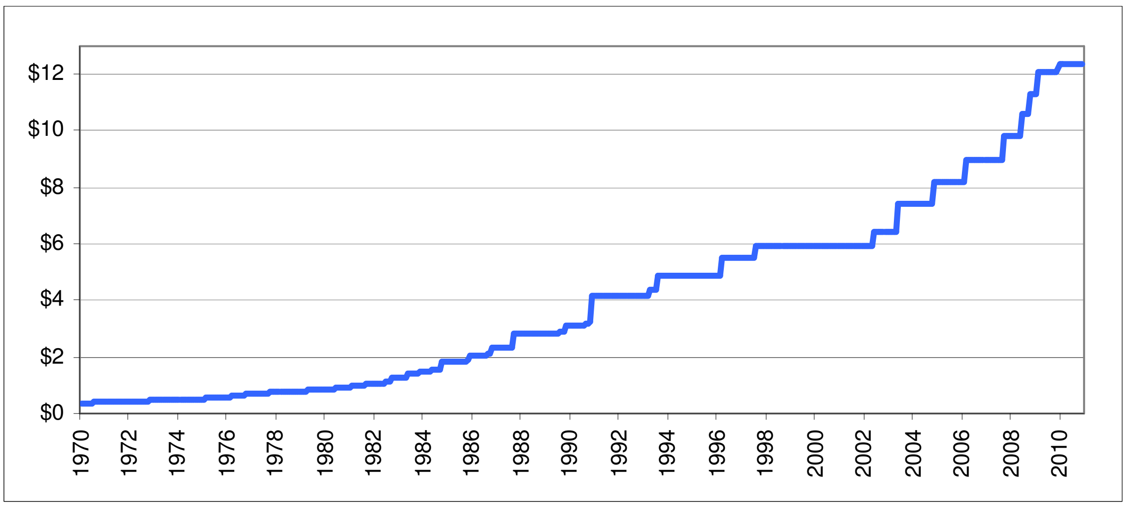
The national debt has become a permanent American fixture. For most of our history however, debt was merely a temporary funding source for wars and other emergency spending needs. Prior to the early 1900s, in fact, Congress had to approve each debt issuance separately.

As the nation and government grew in size and scope, the financial structure of our economy became more complex. Certain events, such as the United States' involvement in World War I, created unparalleled financial commitments, and it became clear that putting a new borrowing mechanism in place would be prudent. In 1917, Congress passed the Second Liberty Bond Act, allowing the flexible issuance of certain bonds. The Act ultimately set these bonds subject to a limit of $11.5 billion.

In 1939 Congress applied this philosophy to nearly all federal debt, and created the first aggregate debt limit set at $45 billion (debt outstanding at the time was $40.4 billion).

Since then, the debt limit has been changed nearly 100 times. Though there have been a few temporary decreases – the most recent having taken place 30 years ago – the debt limit has gradually increased.

Fig. 1: Statutory Debt Limit, 1970 – Present (trillions)



Source: Office of Management and Budget

Recent Increases to the Debt Ceiling

Most recently, the debt ceiling was increased by $290 billion as a stopgap measure in December 2009, and before that by $789 billion as part of the American Recovery and Reinvestment Act in February 2009.

In April 2009 the House passed a debt ceiling increase which would raise it further, to $13 trillion; this action occurred automatically as a part of the April budget resolution vote under the "Gephardt rule."[1] Since the Senate does not have a similar rule, it must take an explicit vote on an increase to the debt ceiling. Democrats will need 60 votes to pass the bill, a margin they barely reached in December when they raised the ceiling by just $290 billion. This supermajority threshold was established as part of a deal struck in December between Minority Leader Mitch McConnell and Majority Leader Harry Reid, which allowed voting to proceed earlier than scheduled on the health care bill in exchange for certain stipulations regarding the debt ceiling vote.

[1] Established in 1980, the Gephardt rule allows the House to consider the increased debt ceiling in the Budget Resolution as having passed by the same vote as the Budget Resolution, allowing lawmakers to shirk the responsibility of actually voting on a debt ceiling increase as a stand-alone bill.

The Senate may vote to raise the ceiling to $14.3 trillion to avoid raising it again until after the 2010 elections. Since this level is $1.3 trillion above than the $13 trillion limit automatically passed in the House, if the legislation passes, it must be sent back to the House for a vote.

Avoiding an Increase to the Debt Ceiling

There are a number of measures that could be taken to postpone increasing the debt ceiling while avoiding defaulting on U.S. loans. Over the past decades, the Treasury has developed new means of keeping the government operational while Congress delays passing increases. While these accounting gimmicks may avert a default, they also can create additional costs, inconveniences, and market uncertainty. The tactics the Treasury has used include:

- Suspending the reinvestment of government securities in federal trust funds – such as the Civil Service fund and the G-Fund for federal employees' Thrift Saving Plan – in order to prevent the growth of intragovernmental debt.
- Suspending the investment of the Civil Service Retirement and Disability Fund.
- Delaying or suspending the auction of Treasury securities, which would prevent the growth of debt held. Before doing this the Secretary must determine that a "debt issuance suspension period exists," which basically means the Secretary has determined that the obligations of the U.S. cannot be issued without exceeding the debt limit, and allows the Treasury to suspend or redeem investments in two trust funds to help provide funds for government operations during this period.
- Redeeming government securities held in the Civil Service Retirement and Disability Fund.
- Redeeming the securities of other trust funds at an earlier date than they would otherwise be redeemed.
- Ceasing to provide state and local governments with non-negotiable U.S. federal debt for escrow accounts.
- Selling part of dollar holdings on the Exchange Stabilization Fund.
- Selling holdings in Fannie Mae and Freddie Mac debt and stock, or assets held by the Treasury through the TARP program.

The Treasury has had to resort to many of these measures in the past, sometimes concurrently. For example, during the 1995-1996 debt ceiling showdown, President Clinton's Treasury Secretary Rubin employed almost all of them. Secretary Rubin declared a debt issuance suspension period, and used the department's authority to suspend investment of the G-Fund and redeem securities held by the Civil Service Retirement and Investment Fund, in order to avoid exceeding the debt ceiling.

Secretary Rubin took Treasury securities held in the fund and exchanged them for non-Treasury securities held by the Federal Financing Bank (FFB). The FFB then redeemed the Treasury securities it had received and repaid borrowings from the Treasury. These actions allowed the FFB to raise additional funds from the public. The Treasury also suspended some G-Fund investments, suspended some reinvestments of maturing Treasury securities, and issued securities that were not counted toward the debt ceiling. The temporary exemption from being counted toward the debt ceiling allowed the Treasury to raise $29 billion to pay March 1996 Social Security benefits payments as well as invest $58 billion from government trust fund receipts and maturing securities in March 1996.

Similar actions were taken a number of times during the Bush administration. In 2002, for example, Treasury Secretary O'Neill suspended reinvestment of government securities in the G-Fund. In 2003, Secretary Snow took a number of actions, including replacing internally held government debt with non-debt instruments in certain accounts. And in 2006 reinvestment in the G-Fund was again suspended, an action which freed up just over $65 billion for the Treasury.

These actions all are within the Treasury's authority, but do not make for good policy. Raiding federal retirement funds and changing debt issuances can be costly, and these actions only put off the inevitable addition of more debt to the federal balance. Moreover, when the Treasury takes these actions to avoid an increase to the debt ceiling, it adds considerable uncertainty to financial markets, which can potentially increase the cost of borrowing, or even damage the economy as a whole.

Dangers of not Raising the Debt Ceiling

If the government were to hit the debt ceiling and run out of options for avoiding an increase, it no longer would be allowed to issue debt. As a result, there would be insufficient funds to pay the most basic government bills – from salaries and utility bills to Social Security payments. At some point, there would not be enough money to cover the government's first obligation – interest payments on past borrowing.

Such a default would roil global financial markets as never before. Both domestic and international financial markets depend on relative economic and political stability, and specifically are influenced by the stability of U.S. debt instruments. A default would undermine the "full faith and credit" associated with U.S. Treasury Bonds, greatly reducing their value. In all likelihood, this would send the domestic and global economies into turmoil.

Yet even if the global economy could avert collapse, taxpayers would suffer. Treasuries would be seen as risky assets for years to come, and could easily lose their AAA rating.

This would scare off investors, which could affect the value of the dollar. Future borrowing would be far more costly for the United States, and global investors would likely turn elsewhere for a safe, benchmark security, causing the United States to lose the advantages that come with being the world's safest investment. As the cost of borrowing increased for the government, economy-wide interest rates would also likely go up. This would depress business investment, make mortgages and student loans less affordable, and ultimately slow economic growth.

Dangers of Debt

While failing to raise the debt ceiling would create a debt crisis, failing to control the debt could eventually do the same. If investors believe the United States may be unable to repay their debt – or may inflate their way out of it – we would likely see a growing refusal to invest in Treasury securities. For a while the government could lure in new buyers through higher interest rates, but higher interest rates would mean both greater costs to the government and slower growth in the overall economy. And ultimately if our mounting debt were not brought under control, we could face a severe economic crisis.

Unfortunately, rather than balancing the nation's books, members of both parties have enacted new tax cuts and spending increases – in good times and in bad – and put the costs on the nation's credit card. When confronted with exceeding the debt limit, they have simply raised it time and again without implementing any policies to bring the debt under control. This time around, for the sake of our budget and economy, we need to do better.