COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Q&A: Everything You Should Know About the Debt Ceiling
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Attention is turning towards raising the federal debt ceiling, which will be reinstated after February 7th. At that point, the limit will be about $17.3 trillion, according to estimates from the Bipartisan Policy Center. At that time, the Treasury Department would have to begin use of a limited amount of accounting tools at their disposal, called extraordinary measures, to avoid defaulting on their obligations. However, even with such measures, the Treasury Department estimates that they will only be able to continue paying the nation's bills until late February, by which point the debt ceiling would need to be raised. The following is a short primer on the debt ceiling and on the ways to responsibly address it while also dealing with unsustainable federal borrowing going forward.

What is the debt ceiling?

The debt ceiling is the legal limit on the total level of federal debt the government can accrue. The limit applies to almost all federal debt (certain types of debt are exempt, but are quite small in value), including the debt held by the public and what the government owes to itself through various accounts, like the Social Security and Medicare trust funds. As a result, the debt subject to limit increases both as a result of annual budget deficits financed by borrowing from the public and trust fund surpluses, which are invested in Treasury bills.

The agreement that ended the government shutdown in October 2013 also suspended the debt limit through February 7th. After that, the statutory debt limit will be reinstated at the amount necessary to encompass all federal borrowing to that date – around $17.3 trillion, according to the Bipartisan Policy Center.[i] That amount will be composed of roughly $12.3 trillion in debt held by the public and $5 trillion in debt held by government accounts. Most economists, however, feel debt held by public is the more relevant measure of the economic impact of government debt.

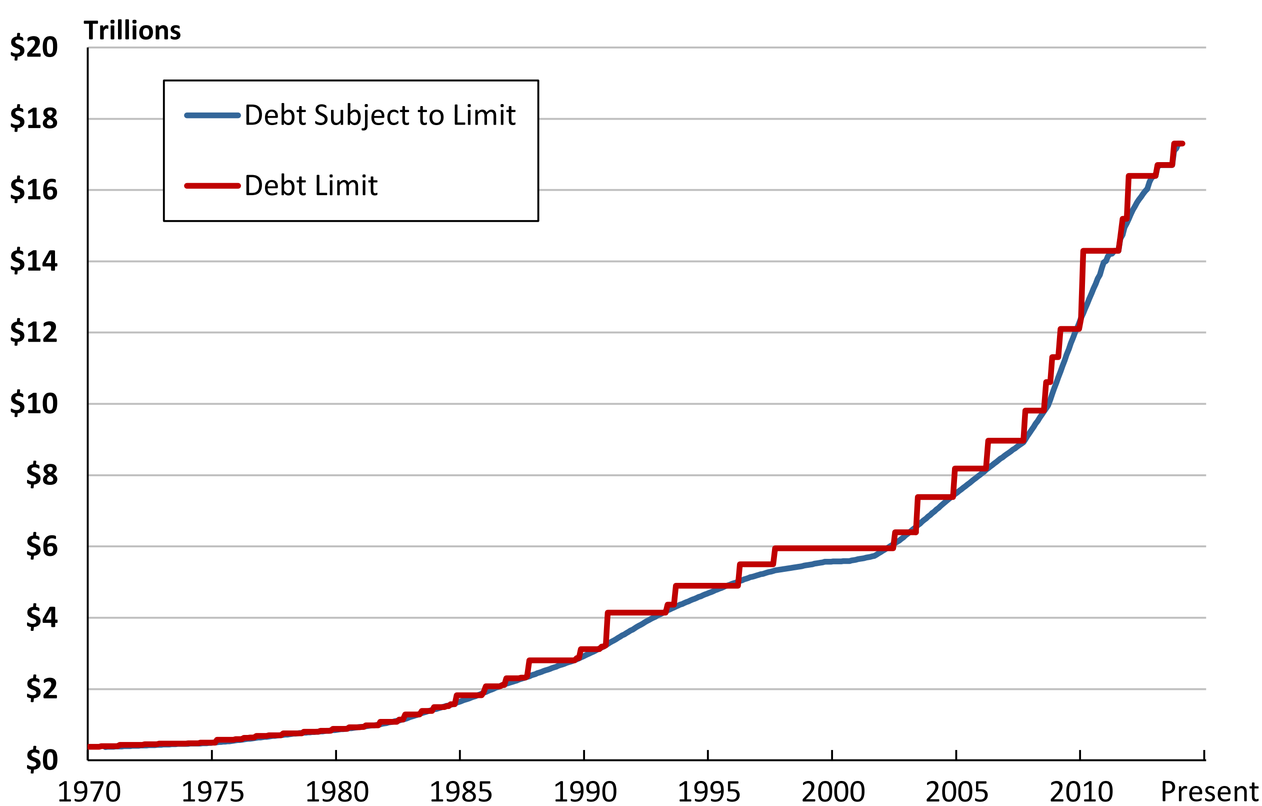
When was the debt ceiling established?

The first iteration of the debt ceiling was established in 1917 and set at $11.5 billion under the Second Liberty Bond Act. Prior to this, Congress was required to approve each issuance of debt separately. The ceiling was enacted to simplify the process and enhance borrowing flexibility. In 1939, Congress created the first aggregate limit covering nearly all government debt and set it at $45 billion, about 10 percent above the total debt at that time.

How much has the debt ceiling grown?

Since it was established, Congress and the President have increased the debt ceiling roughly 100 times. During the 1980s, the debt ceiling increased from less than $1 trillion to nearly $3 trillion. Over the course of the 1990s, it doubled to nearly $6 trillion, and in the 2000s, it again doubled to over $12 trillion. The Budget Control Act of 2011 automatically raised the debt ceiling by $900 billion and gave the President authority to increase the limit by an additional $1.2 trillion to $16.394 trillion. In February of 2013, lawmakers temporarily suspended the debt ceiling through May, resulting in a *de facto* increase of about $305 billion and bringing the debt ceiling to its current level of $16.699 trillion. In October, lawmakers again suspended the debt ceiling until February 7, 2014, which will result in a *de facto* increase around $600 billion and bring the current debt limit up to $17.3 trillion.

Fig. 1: Statutory Debt Limit and Federal Debt Subject to Limit



Sources: Office of Management and Budget

Why is Congress debating this now?

The president signed the Default Prevention Act of 2013 into law on October 17, 2013, which temporarily suspended the statutory debt limit through February 7, 2014. At that point, the debt ceiling will automatically be raised to roughly $17.3 trillion to cover new borrowing since suspension. If the debt limit is not raised further to cover additional borrowing after February 7th, the Treasury will have to employ "extraordinary measures" to avoid breaching the debt ceiling (see more about this below). According to Treasury Secretary Jack Lew, all borrowing authority, including the amount freed up through extraordinary measures, will be exhausted by late February, at which time they would have to rely only on remaining cash on hand and incoming receipts to pay obligations, and a formal debt limit increase or suspension would soon be necessary to avoid default. The Bipartisan Policy Center independently estimates that extraordinary measures and cash on hand will run out between February 28th and March 25th. After this "X Date", the U.S. could only pay obligations with incoming receipts, forcing the Treasury to delay and/or miss many payments since the federal government currently runs substantial deficits in February and March.[ii]

Can hitting the debt ceiling be avoided without Congressional action?

The Treasury Department can use a variety of accounting tricks known as "extraordinary measures" to postpone the need to raise the debt ceiling. For example, it can prematurely redeem Treasury bonds held in federal employee retirement savings accounts (and replace them later plus interest), halt contributions to certain government pension funds, or borrow from money set aside to manage exchange rate fluctuations. Some believe the Treasury Department could buy even more time by engaging in other, unprecedented actions, such as selling large amounts of gold, minting a special large-denomination coin, or invoking the Fourteenth Amendment to override the statutory debt limit. Whether any of these tools is truly available is in question—the Obama Administration has ruled out all three—and the potential economic and political consequences of each of these options are unknown.

What happens if the debt ceiling is hit?

Once the government hits the debt ceiling and exhausts all available extraordinary measures, it is no longer allowed to issue additional debt. At that point, the government must rely on its remaining cash on hand and incoming receipts to pay all obligations. However, when the federal government is in a period of running annual deficits – as is the case today – incoming revenues to the federal government are insufficient to cover all of the government's obligations, be it salaries for federal civilian employees and the military, utility bills, veterans' benefits, or Social Security payments, to name a few.

Traditionally, February is the month with the highest deficit-spending in the year, because the Internal Revenue Service (IRS) sends out many tax refund checks. If this February follows a similar pattern as last year, ***more than half*** of the government's obligations would have to go unpaid once the government is forced to rely on incoming receipts alone to pay bills. If an impasse continued into March, roughly 25 percent of that month's bills would go unpaid. In addition to failing to meet its regular obligations, the government could also potentially default on interest payments on the debt.

A default, or even the perceived threat of a default, could have serious negative economic implications. An actual default would roil global financial markets and create chaos, as both domestic and international markets depend on the relative economic and political stability of U.S. debt instruments and the U.S. economy. Interest rates would rise as demand for Treasuries would account for the increased risk of default, with demand for Treasury bills dropping as investors stop or scale back investments in Treasury securities if they are no longer considered a perfectly safe investment. Even the threat of default can raise borrowing costs: GAO has estimated that the 2011 debt limit debate led to higher interest rates on Treasuries issued during the standoff based on concerns about a potential default, which cost the federal budget $1.3 billion that year and an estimated $19 billion over a decade, according to extrapolations from the Bipartisan Policy Center.[iii] An actual default would have a far greater and longer-lasting effect on interest rates than the potential default during the 2011 standoff.

Higher interest rates for Treasuries would increase interest rates across the economy, affecting car loans, credit cards, home mortgages, business investments, and other costs of borrowing and investment. The balance sheets of banks and other institutions with large holdings of Treasuries would decline as the value of Treasuries dropped, potentially tightening the availability of credit.

How does a shutdown differ from a default?

In a shutdown, government temporarily stops paying employees and contractors who perform government services, whereas the list of parties not paid in a default is much broader (See Q&A: Everything You Should Know About Government Shutdowns). In a default, the government exceeds the statutory debt limit and is unable to pay on time some of its obligations to its citizens or creditors. Without enough money to pay the bills, any of its payments are at risk, including all government spending, mandatory payments, interest on our debt, and payments to U.S. bondholders. Whereas a government shutdown would be disruptive, a government default could be disastrous.

Have policymakers used the debt ceiling to pursue deficit reduction in the past?

Although policymakers have often enacted "clean" debt ceiling increases, Congress has coupled such 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.

Indeed, 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.

Notably, in nearly all instances in which a debt limit increase was either accompanied by deficit-reduction measures or included in a deficit-reduction package, lawmakers have generally approved temporary increases in the debt limit to allow time for negotiations to be completed without the risk of default. For example, Congress approved a modest increase in the debt limit in December 2009 while negotiations over Statutory PAYGO and establishment of the National Commission on Fiscal Responsibility and Reform were ongoing. During the negotiations and consideration of the 1990 budget agreement, Congress approved six temporary increases in the debt limit before approving a long-term increase in the limit as part of the reconciliation bill implementing the deficit-reduction agreement.

Further discussion regarding past uses of the debt ceiling can be found in the Appendix.

What should policymakers do?

Failing to raise the debt ceiling would be disastrous. It would result in severe negative consequences that experts are not capable of fully knowing in advance. Even threatening a default or taking the country to the brink of default could have serious negative repercussions. Importantly, though, failing to control the debt could ultimately stunt economic growth, reduce fiscal flexibility, and increase the cost burden on future generations. But political advantage should not be sought by bringing America close to the brink of default. If lawmakers wish to accomplish deficit reduction, they should at least pass temporary increases of the debt limit to avoid nearing the brink.

Given these risks, Congress and the President must raise the debt ceiling – and they should do so as soon as possible. Yet they should also continue to work toward putting our debt on a sustainable long-term path. Specifically, policymakers should observe strict adherence to pay-as-you-go rules, reform the tax code to encourage growth and raise more revenue, and slow the growth of entitlement programs so they are affordable for future generations.

Although the need to raise the debt ceiling can serve as a useful moment for taking stock of our fiscal state, lawmakers must not jeopardize the full faith and credit of the U.S. government.

Where can I learn more?

- Committee for a Responsible Federal Budget – Understanding the Debt Limit
- Bipartisan Policy Center – Debt Limit Analysis
- The Treasury Department – Debt Limit Resources
- Committee for a Responsible Federal Budget – Debt Ceiling Tracker 2013
- Government Accountability Office – Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs
- Congressional Budget Office – Federal Debt and the Statutory Limit, November 2013

Appendix: Examples of How Debt Ceiling Has Been Used in the Past

The Gramm-Rudman-Hollings Act in 1985: The Gramm-Rudman-Hollings Act (GRH) in 1985 raised the debt limit by $175 billion and also set a target to have a balanced budget by 1991, with across-the-board cuts in spending by sequestration designed as an enforcement mechanism. Although the deficit-reduction goals under GRH were not fully achieved, the experience gained under the act contributed to the development of more workable and effective procedures five years later.

Omnibus Budget Reconciliation Act of 1990: The Omnibus Budget Reconciliation Act (OBRA) of 1990 raised the debt limit by $915 billion, the largest increase up until that point, but also contained nearly $500 billion in deficit reduction over the next five years and created enforcement procedures in the Budget Enforcement Act (BEA), which helped lead to the budget surpluses in the late 1990s. The BEA created adjustable limits for separate categories of discretionary spending and the pay-as-you-go (PAYGO) procedure that required tax cuts or increases in mandatory spending to be offset. Congress approved six temporary increases in the debt limit while negotiations were ongoing and Congress was considering legislation implementing the budget agreement.

Omnibus Budget Reconciliation Act of 1993: The Omnibus Budget Reconciliation Act of 1993 raised the debt limit by $600 billion, an increase that lasted for about two and a half years. OBRA '93 was the second major deficit-reduction package of the 1990s, also containing nearly $500 billion in deficit-reduction over five years. The agreement extended the original spending caps from 1990 and raised taxes on high earners, among other reforms.

Balanced Budget Act of 1997: The Balanced Budget Act of 1997 included a $450 billion debt limit increase which, thanks to the surpluses of the late 1990s and early 2000s, was enough to cover debt until 2002. At the time, the legislation called for about $125 billion of net deficit reduction over five years and $425 billion over ten years. It did so mainly through reductions in health care spending via provider payment reductions and increased premiums. The Act also created a few new programs – Medicare+Choice (later renamed Medicare Advantage or Medicare Part C) and the State Children's Health Insurance Program (SCHIP).

Statutory PAYGO Act of 2010: The Statutory PAYGO Act of 2010 contained a debt limit increase of $1.9 trillion, the largest nominal increase ever enacted until that point in time. The legislation also reinstituted statutory PAYGO procedures that require tax cuts and mandatory spending increases to be fully offset (with some exemptions). Informally, the agreement to raise the debt ceiling also led to the creation of a National Commission on Fiscal Responsibility and Reform, to which President Obama later appointed Erskine Bowles and former Senator Al Simpson as co-chairs.

Budget Control Act of 2011: The Budget Control Act (BCA) gave the President the authority to increase the debt limit in tranches – subject to a Congressional motion of disapproval – by a total of **$2.1 trillion.** The BCA also contained $917 billion in deficit reduction over ten years, primarily through caps on discretionary spending. In addition, the bill established the Joint Committee on Deficit Reduction ("Super Committee") to produce deficit-reduction legislation of at least $1.2 trillion in savings, with budget sequestration to begin in 2013 as an enticement for the Super Committee to succeed. The bill also required Congress to vote on a Balanced Budget Amendment, which it did not pass.

No Budget, No Pay Act of 2013: Lawmakers enacted the No Budget, No Pay Act in early February of 2013, which temporarily suspended the debt ceiling through May 18th, 2013 and then set an automatic "catch up" on May 19th that allowed for a **$300 billion** increase in the debt ceiling. The agreement would have also withheld the pay of Members of Congress if no budget resolution was passed in each House (though there was no requirement that the resolutions being agreed to jointly, which is necessary to go forward with the budget process).

Default Prevention Act of 2013: The Default Prevention Act of 2013 ended a 16-day partial shutdown of the federal government by funding the government through January 15, 2014 and suspending the debt ceiling until February 7, 2014. This agreement set up a bicameral budget conference to reconcile budgets for Fiscal Year 2014, and provided for an automatic "catch up" on February 7th. On that date, the debt ceiling would be reinstated at the current level of borrowing, resulting in a *de facto* increase of about $600 billion and bringing the debt ceiling to $17.3 trillion.

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[i] Bipartisan Policy Center, "Debt Limit Analysis," available at http://bipartisanpolicy.org/library/staff-paper/debt-limit, accessed January 27, 2014.
[ii] Bipartisan Policy Center, "BPC Debt Limit Projection: X Date Will Arrive Soon After Debt Limit Reinstatement," available at http://bipartisanpolicy.org/blog/2014/01/30/bpc-debt-limit-projection-x-date-will-arrive-soon-after-debt-limit-reinstatement, accessed January 30, 2014.
[iii] Government Accountability Office, "Analysis of 2011-2012Actions Taken and Effect of Delayed Increase on Borrowing Costs," July 2012; Bipartisan Policy Center, "BPT Debt Limit Projection."