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UNDERSTANDING THE FEDERAL DEBT LIMIT September 12, 2007

Federal borrowing is once again approaching the statutory debt limit. Treasury Secretary Henry M. Paulson notified Congressional leaders in a letter July 30, 2007 that the statutory debt limit will be reached in early October 2007. “The actions that are available to the Treasury Department to take in order to avoid breaching the statutory debt limit would create unnecessary uncertainty for the financial markets and result in costs to the government.”¹ This brief answers common questions about the statutory debt limit and the need to increase it.

What is the debt limit and why is it important? Since 1941, Congress has established in law the maximum amount of debt the federal government may issue. The Treasury does not have legal authority to issue any debt *above* this statutory limit. To avert a default on its credit obligations or a shutdown of government operations, occasionally it is necessary to raise the limit. The current statutory debt limit, \$8.97 trillion, was established in March 2006.

Raising the Debt Limit	
Date	Debt Limit
August 1997	\$5.95 trillion
June 2002	\$6.40 trillion
May 2003	\$7.38 trillion
November 2004	\$8.18 trillion
March 2006	\$8.97 trillion

Debt subject to limit has two components: (1) debt held by the public — debt held by any individual or entity that is not the federal government such as a mutual fund, individual investor, foreign government, or a municipal government; and (2) intragovernmental debt — debt the government owes itself such as the

Social Security Trust Funds, the Medicare Hospital Insurance Trust Fund, and the Civil Service Retirement and Disability Fund.

There is a small amount of the “total debt outstanding” that does not fall under the debt limit. That is why the numbers commonly reported as the “national debt” might at times look larger than the debt limit.

Debt held by the public. When revenues received by the Treasury are not sufficient to meet the expenses of the federal government, the Treasury borrows to obtain the cash necessary to meet its obligations. Although much of the federal revenue used to finance government operations is received in the spring when individuals file their annual income tax returns, the federal government incurs a steady stream of operating costs all year long. Consequently, to smooth cash flow and enable the federal government to finance daily operations, the Treasury borrows money by selling securities to the public. These securities comprise the debt held by the public. Debt held by the public rises and falls depending on the government’s immediate borrowing needs. It represents the cumulative amount of borrowing required to finance budget deficits. Because debt held by the public flows through financial markets, it has more immediate relevance to the economy than intragovernmental debt, which is a matter of internal bookkeeping. As of the end of August 2007 debt held by the public (subject to limit) totaled \$5.06 trillion.

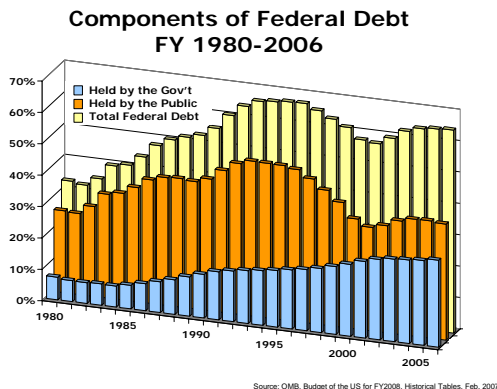
Intragovernmental debt. For the most part, intragovernmental debt consists of trust fund accounts that are credited with dedicated revenue such as Social Security and Medicare payroll taxes (FICA). In theory, surpluses in these accounts are “saved” for future benefit obligations. As of the end of August 2007

¹ Letter to the Honorable Charles Rangel, Chairman, House Committee on Ways and Means, US House of Representatives, July 30, 2007.

intragovernmental debt (subject to limit) totaled \$3.86 trillion.

Intragovernmental debt increases automatically every year by the amount of trust fund surpluses invested in Treasury securities, regardless of whether the budget is in surplus or in deficit. For example, in every year since 1984 the Social Security program has generated a surplus – the federal government has collected more payroll taxes than it needed to pay current benefits. Surplus payroll taxes are held by the Social Security Trust Fund in the form of special obligation bonds. In addition, the trust fund is credited with interest on its balance in the form of additional bonds. As Social Security surpluses grow, so too does the Social Security Trust Fund, and intragovernmental debt rises. Thus, unlike debt held by the public, growth of intragovernmental debt does not reflect an imbalance in short-term fiscal policy. It represents a very different problem – growing long-term obligations that future taxpayers will have to pay for when the Treasury ultimately has to transform these bonds into benefits.

What is driving the need to raise the debt limit? Unchecked growth in either category of debt will generate pressure to raise the debt limit. For FY 2007, the Congressional Budget Office (CBO) estimates that total debt will go up by \$448 billion. Of that, \$164 billion (37 percent) is attributable to an increase in debt held by the public and \$284 billion (63 percent) is attributable to an increase in intragovernmental debt.²



To understand the role of each component relative to the debt limit, consider the brief

² CBO, *The Budget and Economic Outlook: An Update*, August 2007, Table 1-7, p. 16.

period in 1998-2001 when four years of budget surpluses allowed the federal government to buy back, or “pay down,” \$453 billion in debt held by the public. Over those same four years, intragovernmental debt increased by \$853 billion (largely due to substantial Social Security surpluses credited to the Social Security Trust Fund). As a result, the total debt subject to limit rose from \$5.3 trillion in 1997 to \$5.7 trillion at the end of FY 2001.

When Congress increased the debt limit in 2002 from \$5.95 trillion to \$6.4 trillion, debt held by the public was actually *lower* than it had been when the debt limit was previously increased in 1997. The limit was raised to accommodate the increase in intragovernmental debt.

Congress could avoid future trust fund-induced increases in the debt limit if it “saved” trust fund surpluses by running total, or “unified,” budget surpluses equal to the trust fund surpluses and making corresponding reductions in debt held by the public. If the increase in intragovernmental debt, which mostly represents future obligations, were offset by an equivalent reduction in debt held by the public, the budget and the economy would be better prepared to make good on those future obligations.³ Following this strategy, however, would require substantial budget surpluses and a degree of political cooperation and fiscal discipline that is not currently in evidence.

What is the status of Congressional legislation raising the debt limit? When the House adopted the conference report for the FY 2008 budget resolution (H. Rept. 110-153), it triggered House Rule XXVII (also known as the “Gephardt Rule”). The rule automatically produced a joint resolution (H.J.Res. 43) raising the debt limit to \$9.815 trillion (an increase of \$850 billion). The resolution, according to the rule, was “deemed”

³ As explained by the Office of Management and Budget (OMB): “From an economic standpoint, the Government is able to prefund benefits only by increasing saving and investment in the economy as a whole. This can be fully accomplished only by simultaneously running trust fund surpluses equal to the actuarial present value of the accumulating benefits and not allowing the federal fund deficit to increase, so that the trust fund surplus reduces a unified budget deficit or increases a unified surplus. This would reduce Federal borrowing by the amount of the trust funds surplus and increase the amount of national saving available to finance investment. Greater investment would increase future incomes and wealth, which would provide more real economic resources to support the benefits.” FY 2006 Budget of the U.S., *Analytical Perspectives*, p.375.

passed and then sent to the Senate as a separate measure in May 2007. The Senate Finance Committee passed the House's increase September 12, and the legislation awaits action by the full Senate.

If Congress fails to act, what are the options the Treasury has to avoid breaching the debt limit? The U.S. Treasury can employ a few financial maneuvers to avoid breaching the debt limit and defaulting on the national debt. These transactions are benign and completely legal, but in the wake of the corporate accounting scandals in 2002 they are a source of unease among lawmakers and the public. Moreover, all of these machinations merely postpone the inevitable – an increase in the statutory debt limit.

Specifically, the Treasury can:

- *Suspend reinvestment of government securities in federal trust funds such as the G-Fund of the federal employee's Thrift Saving Plan (TSP) or the Civil Service Retirement and Disability Fund (CSRDF).* Such action prevents this part of the intragovernmental debt from growing. Manipulating retirement funds may sound ominous, especially to federal employees, but laws enacted in the 1980s require the Treasury to restore all due interest and principal to the fund as soon as it can.
- *Delay or suspend the auction of public debt instruments.* This action prevents debt held by the public from growing. Individuals and institutional investors regularly purchase Treasury securities for investment purposes. The revenue from the sale of securities is then used to manage the cash flow needs of the federal government. Therefore, suspending the sale of T-bills can be very disruptive to domestic and international financial markets as well as the operations of the federal government.

Has the Treasury resorted to similar tactics before? Yes. The Clinton Administration undertook similar measures in 1995 and 1996, and the Bush Administration resorted to such tactics in 2006, 2004, 2003 and *twice* in 2002.

How did we get to this point? In January 2007, debt subject to limit was \$8.619 trillion – \$345 billion below the statutory debt limit. Recognizing the likelihood that it would need to

raise the debt limit in the not-too-distant future, Congress included provisions in the FY 2008 budget resolution to raise the debt limit by \$850 billion to \$9.815 trillion. Because raising the debt limit is a political “hot potato” – a vote that many legislators seek to avoid – the budget resolution contained special procedures and protections to expedite action on the debt limit and minimize the political risk in approving the increase. However, the different procedures for increasing the debt limit in the House and Senate – and the desire by both chambers to avoid such a vote – put the two chambers at odds with each other.

When the House passed the FY 2008 budget resolution, the Gephardt Rule allowed the House to pass a separate increase in the debt limit *without a recorded vote* (legislation increasing the debt limit was “deemed” passed with passage of the budget resolution).

Thus, the Senate had two ways to deal with the debt limit issue. It could pass its own standalone legislation, which the House would then have to approve by recorded vote – a scenario House leaders preferred to avoid. Instead, it looks like the Senate will take up the House-deemed legislation as passed through the Senate Finance Committee. However, that means the legislation will be subject to amendments (including politically motivated ones) that might lead to damaging extended debate – a scenario Senate leaders would prefer to avoid.

If the past is a guide, Senate leaders may stall until the last possible moment and then bring up the House-deemed debt limit increase. At that time, Treasury might have exhausted nearly all its cash management options and Congress will be eager to adjourn for a planned recess. This combination of events could effectively preclude any opportunity for lengthy debate or amendments and ensure swift passage of an increase in the debt limit. This scenario is similar to what the Senate did in 2003 and 2006.

What should Congress do?

Raising the debt limit is essentially a decision to pay the bills. Political leaders must rise above partisan gamesmanship and increase the debt limit to avoid a damaging and unnecessary debt crisis. Approval of a debt limit increase is necessary to maintain the full faith and credit of the United States government. Failure to approve

an increase would have dire consequences for government finances and financial markets. Delaying action on an increase until the last possible moment, forcing Treasury to utilize extraordinary measures to avoid a default, is unnecessary and irresponsible.

Unlike budget enforcement mechanisms such as statutory spending caps or the pay-as-you-go (PAYGO) rules recently adopted by Congress for entitlement expansions and tax cuts, the debt limit places no restrictions on specific tax and spending decisions. If deficits result from these policy decisions, or if the economy fails to grow as projected, the debt limit must be increased to prevent a default on the government's obligations.

However, the need to raise the debt limit does provide an opportunity to assess past fiscal decisions and, if necessary, make course corrections. In the past, major increases in the debt limit have often been accompanied by the enactment of deficit reduction plans such as the November 1990 increase of \$915 billion, the August 1993 increase of \$530 billion, and the August 1997 increase of \$450 billion. In the absence of such linkage Congress has been reluctant to raise the debt limit by more than is necessary to get through a short period of time. Thus, while the debt limit is not, by itself, a fiscal firewall, in the absence of other more effective mechanisms, it is one of the few budgetary speed bumps left to provide a sense of fiscal discipline. For this reason, both the House and Senate should debate and vote on the debt limit. If Members of Congress find it embarrassing or distasteful to vote on a debt limit increase, the remedy is to enact more responsible fiscal policies.

Congress and the President should use the need for action on the debt limit as an opportunity to develop a specific and realistic plan to put the country on a sustainable fiscal path. Alternatively, they could pair the debt limit increase with statutory PAYGO and spending caps and/or the appointment of a bipartisan commission to develop a sustainable fiscal policy plan.

While the Bush Administration and Congress each claim to have balanced budget plans, neither uses realistic assumptions and both are incompatible with one another — a recipe for inaction and stalemate. Using realistic

assumptions, current policy is projected to add another \$5 trillion to the publicly held debt over the next 10 years. Beyond then, things will get even worse as the retirement of the baby boom generation hits full stride.

Current policy is not sustainable. The rationale for confronting this problem along with a debt limit increase is clear: greater flexibility to increase the debt is allowed, but only within the context of a fiscally responsible budgetary framework.