Backgrounder

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Congress Has Time and Options on Debt Limit

J. D. Foster, Ph.D.

Abstract: *The massive federal budget deficit is unsustainable today because of out-of-control spending. Consequently, the federal government is about to run up against its statutorily imposed debt limit. Fortunately, Congress has options, and it has time to consider them carefully. If Congress chooses not to raise the debt ceiling, then it could act swiftly to indicate that net interest is the highest priority to allay any remaining concerns about the possibility of defaulting on the debt. Congress could also declare exactly where spending should be cut to align total spending with receipts, not leaving this to a President acting without statutory guidance. If Congress inclines toward raising the debt limit, then it should also impose immediate, substantial spending reductions along with strong new rules such as hard spending caps to require continued, sharp spending reduction in future years. The outcome should reflect a clear, quick path to a sound fiscal policy. The responsibility for driving down spending and borrowing rests—under our Constitution—squarely with the Congress and the President of the United States.*

Congress has time to consider carefully the options available as the U.S. government reaches its statutory debt limit, exhausting its authority to borrow from credit markets.[1] As the government runs up against its limit of $14.294 trillion, Congress and the President face the decision whether to raise the limit and thereby permit continued borrowing. The government may initially reach the debt limit in early spring, but the timing of tax receipts and the U.S. Department

Talking Points

- As the debt limit approaches, Congress has a unique opportunity to bring federal spending and budget deficits under control for 2011 and beyond.
- One option is to hold the debt limit in place, thereby forcing an immediate reduction in non-interest spending averaging about $125 billion each month. Congress could also consider legislation providing even more detailed direction as to how the Administration should prioritize spending.
- A second option is an increase in the debt limit that is accompanied by substantial, immediate spending reductions. Each such cut means less debt the federal government must issue and that much less net interest it must pay forevermore.
- A third option is to raise the limit and enact tough budget reforms. Congress could adopt strict spending caps for total spending each year, backed by automatic sequestration triggers and other protections to prevent Members from waiving the rules.

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214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

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of the Treasury's well-understood fiscal management tools will provide Congress an additional month or two necessary for a full debate on the options and their consequences.[2]

Whatever course Congress chooses, its deliberations should not be tainted with misplaced concerns over whether the United States government might default on its debt. Contrary to the clear implications of a letter from Treasury Secretary Timothy Geithner to Congress dated January 6, 2011, refusing to raise the debt limit would not, in and of itself, cause the United States to default on its public debt.[3] Both immediately and long after it reaches the debt limit, the government would have far more than enough revenue coming in that the Secretary of the Treasury could use to pay interest on the debt. Nor would preserving the current debt limit put at risk the full faith and credit of the United States government, as the President's chief economic adviser has claimed.[4] The government would continue to pay net interest as it comes due.

Raising the debt limit should not be the first option, but rather the last resort, and should be accompanied by immediate, substantial spending reductions and other actions to set the nation on a path to reduced spending and borrowing.

At the same time, however, Congress should recognize that holding the debt limit at its current level would force a massive restructuring of federal spending to an extent that is little appreciated. All federal deficit spending—equivalent to about $1.5 trillion in 2011, or roughly equal to all security and non-security discretionary spending—would have to cease immediately.[5]

Given this possibility, Congress could consider legislation providing clear guidance as to the broad prioritization of federal spending in the event the government is unable to continue deficit finance. For example, legislation could clearly indicate that net interest on public debt would receive the first claim on income tax receipts, thus eliminating any remaining shred of substance from the question of default. Legislation could also clarify the high priority that should be accorded national security spending and any other clearly high-priority spending programs.

In light of the nation's fiscal plight, raising the debt limit should not be the first option, but rather the last resort, and should be accompanied by immediate, substantial spending reductions and other actions to set the nation on a path to reduced spending and borrowing.

Congress has time to consider all of its options. It should now achieve as much correction of bad federal spending and borrowing habits as possible and put the nation firmly on a path to bring spending and borrowing down substantially.

The Size of the Problem

The debt limit applies to the public debt, also known as the "gross debt," which includes debt the government has sold in the credit markets plus debt the federal government has issued internally to record certain intergovernmental transfers such as transfers from the general fund to Social Security. Credit markets, naturally enough, are concerned only with the debt that is sold to and traded in the markets, called "publicly held debt."

The federal government is rapidly approaching its debt limit because it spends too much, which yields ongoing and massive budget deficits. Wash-

1. Section 3101 of Title 31 of the United States Code sets the dollar limit on the public debt.
2. The debt limit is also sometimes referred to as the "debt ceiling." The two expressions are entirely synonymous.
3. See letter from Secretary of the Treasury Timothy Geithner to Hon. Harry Reid, Majority Leader, United States Senate, and all other Members of the 112th Congress, January 6, 2011, at *http://www.treasury.gov/connect/blog/Pages/letter.aspx*.
4. See transcript of interview with Austin Goolsbee on "This Week," ABC News, January 2, 2011, at *http://abcnews.go.com/ThisWeek/week-transcript-white-house-adviser-austan-goolsbee/story?id=12522822*.
5. See Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011 to 2021," January 2011, at *http://www.cbo.gov/doc.cfm?index=12039*.

ington is borrowing at a staggering rate. The budget deficit is projected to remain at around $1.5 trillion in 2011, following a deficit of $1.3 trillion in 2010.[6] At nearly 10 percent of GDP,[7] these represent the largest budget deficits since World War II, far eclipsing the previous record deficit of 6 percent of GDP set in 1983.

Given that Washington will spend $3.7 trillion in 2010, a projected $1.5 trillion deficit for 2011 means that government borrowed nearly 40 cents of every dollar that it spent. This is the equivalent of financing the entire discretionary budget—which includes defense, homeland security, international, transportation, education, veterans' health, housing, justice, natural resources, environment, and community development spending—with borrowed funds.

A change of course in federal spending is inevitable. The question is whether it will be orderly, beneficial change brought by design or disorderly, harmful change brought by disaster.

Excessive spending levels determined in years past, the recession, and the government's response to the recession are the chief drivers of today's crisis-level budget deficits. Spending will shoot up to 24.7 percent of GDP in 2011 from 19.6 percent in 2007 partly as a result of automatic increases in spending that did not require new legislative action (for example, from more people signing up for food stamps and Medicaid). However, much of the increase in spending resulted from Congress passing an $814 billion "stimulus" law as well as other spending expansions in a misguided attempt to spend its way out of the recession. At the same time, tax revenues that stood at 18.5 percent of the economy in 2007 have dipped to 14.8 percent as the economy contracted and there was less income and business activity for the government to tax.

Going forward, economic recovery is expected to restore revenues to their 18 percent of GDP historical average or more by the end of the decade even if all of the 2001 and 2003 tax cuts are made permanent.[8] However, the escalating costs of Social Security, Medicare, Medicaid, and net interest, combined with large spending expansions signed into law by President Obama, are set to push federal spending past 26 percent of GDP by decade's end. The result by 2020 would be a $1.9 trillion annual deficit and the debt held by the public reaching 100 percent of GDP—and even that gloomy scenario assumes a return to peace and prosperity.[9]

Bottom line: The federal debt held by the public (the total amount of outstanding debt that Washington has borrowed from the financial markets, setting aside the borrowing the government does from its trust funds) stood at $3.4 trillion in 2001, rose to $5.8 trillion by 2008, and leapt to $9 trillion by 2010. Assuming that current tax-and-spending policies continue, publicly held debt will top $23 trillion by the end of the decade.[10] Leaving future generations such a legacy of debt is unacceptable. It would also be unsustainable financially and disastrous economically.

A change of course in federal spending is inevitable. The question is whether it will be orderly, beneficial change brought by design or disorderly, harmful change brought by disaster. Reaching the debt limit provides the critical moment to force the necessary action to reduce spending and borrowing.

The Source of the Debt Limit

Section 8 of Article 1 of the Constitution of the United States vests Congress with "Power…To bor-

6. For comparison, deficits averaged about $213 billion a year from 2002 to 2008.
7. GDP is the gross domestic product of the United States and measures the total output of the economy in goods and services.
8. These tax provisions were recently renewed for two years by Public Law 111-312, December 17, 2010.
9. Based on a current-policy budget baseline. See Brian M. Riedl, "New CBO Budget Baseline Reveals Permanent Trillion-Dollar Deficits," Heritage Foundation *WebMemo* No.3121, January 26, 2011, at *http://www.heritage.org/Research/Reports/2011/01/New-CBO-Budget-Baseline-Reveals-Permanent-Trillion-Dollar-Deficits.*
10. *Ibid.*

row money on the credit of the United States….” Congress then, by law, delegates the exercise of this power to the Treasury Department. The borrowing power is a natural extension of the related authorities vested in the Congress to raise revenues and appropriate funds. In exercising these related fiscal powers, Congress places a limit on the amount of federal debt that the government may issue at any one time to borrow money.

The level of publicly held debt at any one time reflects the extent to which the federal government has engaged in deficit finance. The level of debt is a summary statement of the financial consequences of past actions. In contrast, the need to raise the debt limit reflects an intention to continue deficit financing, effectively distilling the financial implications of current policy and forcing debate, discussion, and ultimately affirmation of current policy if the limit is increased. Thus, contrary to a popular refrain, raising the debt limit reflects current decisions and not just past policy.

Congress could dispense with the periodic ritual of raising the debt limit. It could simply give Treasury the authority to borrow such funds as are needed to carry out the deficit consequences of current fiscal policy. This would be the easier course politically, but Congress has wisely chosen not to take it. The nation is far better served when Congress is forced to acknowledge the net effects of its policies as reflected in the necessity of raising the debt limit to maintain that course. The perceived necessity of raising the debt limit also creates a climactic opportunity for Congress to make crucial policy course corrections that might otherwise prove too difficult in the course of the regular annual budget and appropriations process.

Contrary to a popular refrain, raising the debt limit reflects current decisions and not just past policy.

The Treasury traditionally has been vigilant in warning that the federal debt is approaching the statutory limit. Once the limit is effectively reached, Treasury has a small, limited toolbox of financial management devices that it then uses to buy additional time for congressional action before actual spending becomes strictly limited by receipts. For example, Treasury could create about $200 billion in additional borrowing room under the limit if it chose not to refinance certain cash management bills allocated to the Supplementary Financing Program (SFP).[11] The Treasury may also delay making deposits to certain accounts and to redeem securities in the Thrift Savings Plan's G Fund, the Civil Service Retirement and Disability Fund, and the Exchange Stabilization Fund.[12]

When budget deficits were on the order of 2 percent or 3 percent of the economy, these Treasury tools could allow federal spending to continue unabated for some months. With deficits today on the order of 10 percent of the economy, these tools may only bridge the government's cash flow for a couple of months, depending on the time of year (because the amount of tax revenues flowing into the government during a year varies substantially from month to month).[13]

Managing the Government's Finances After Hitting the Limit

The amount of debt the federal government is allowed to issue is set by statute. Federal spending is similarly established by law.[14] Treasury is at once

11. The SFP is an account at the Treasury created to assist the Federal Reserve in its operations in support of the financial system. See Federal Reserve Bank of New York, "Statement Regarding Supplementary Financing Program," September 17, 2010, at *http://www.ny.frb.org/markets/statement_091708.html*.
12. See Congressional Research Service memorandum, "Reaching the Debt Limit," December 28, 2010.
13. While federal spending is generally fairly well distributed over the course of the year, federal receipts demonstrate a very uneven monthly pattern. Whereas receipt levels in February and March are traditionally relatively low, receipts are traditionally exceptionally high in April with the tax filing season and again in June with quarterly tax filings. Thus, the timing of when the debt limit is reached is very important to policy.
14. Section 9 of Article I of the Constitution provides that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law…."

prohibited by law from issuing additional debt above the limit and obligated by law to spend certain amounts for designated purposes. If the federal government were to reach the debt limit and Treasury's financial management tools were exhausted, then government spending would be limited to incoming receipts beginning in late spring or early summer. At that point, the law setting a debt limit and the laws in place directing government spending would conflict: Something would have to give.

The legal prohibition on government's selling additional debt because government borrowing has reached the statutory limit does not translate into an inability to spend (because tax money is still coming in). Thus, the consequences of reaching the debt limit are quite different from the consequences of a "government shutdown" as a result of the inability of Congress and the President to agree on spending levels for government agencies.

A President acting alone to decide which government bills to pay and which not to pay, operating without statutory authority, is anathema in a democracy based on law.

Very simply, reaching the debt limit means that spending is limited by revenue arriving at the Treasury and is guided by prioritization among the government's obligations. How the government would decide to meet these obligations under the circumstances is a matter of some conjecture. Certainly, vast inflows of federal tax receipts—inflows that are far more than needed to pay monthly interest costs on debt—would continue.[15] Thus, the government has never defaulted on its debt. Whether Treasury is required as a matter of law to prioritize incoming receipts to pay interest costs first is an open question, but there appears to be little doubt Treasury would do so.[16] There is, therefore, no real question that Treasury would take the actions necessary to preserve the full faith and credit of the U.S. government and avoid defaulting on debts due.

The issue is less clear-cut with regard to all other spending obligations. With insufficient funds on hand, after paying interest on its debt, to make all of the expenditures that appropriations laws require, the Treasury would be forced to prioritize what gets paid now and what gets put off. If spending must be funded out of receipt levels that are insufficient to meet all obligations, it appears that an ever-growing backlog of unmet bills (excluding net interest) would ensue until Congress took action one way or another. In 2011, the federal government is expected to run an average monthly deficit, exclusive of net interest costs, of about $125 billion.

Some may argue that Treasury has an implicit authority to prioritize spending on programs that have dedicated revenue sources. For example, the Social Security payroll tax provides a dedicated revenue source. Whether such authority exists or not, the fact remains that benefits have been paid on time during past episodes when the debt limit was reached. In some cases, Congress legislated specifically to ensure that Social Security benefits would be paid, thus eliminating any doubt.

The Treasury would face a difficult question after the government reaches the debt limit and continues to pay as first priority the interest on debts coming due. The situation, in essence, would be this:

1. The Treasury does not have enough money to pay out all of the appropriations made;
2. Congress has, by law, said that the Treasury must carry out all appropriations laws and cannot refuse to carry out a portion of them (an action called "impoundment" that was prohibited years ago by law); and
3. Congress has, by law (the debt limit statute), said that the Treasury cannot borrow to supple-

15. See U.S. General Accounting Office, *A New Approach to the Public Debt Legislation Should Be Considered*, September 1979, at *http://www.archive.gao.gov/f0302/110373.pdf*.
16. See Section 3123 of Title 31 of the United States Code, which says that "[t]he Secretary of the Treasury shall pay interest due or accrued on the public debt." Section 3123 does not provide guidance, however, on how to implement Section 3123 and other statutes directing expenditures when there is not enough cash on hand at the Treasury to cover all of the directed expenditures.

ment income tax receipts to pay the government's bills.

In short, the Treasury would not have enough money to go around. Although the law generally does not appear to tell the President what he must do in that situation, some may argue that, as a practical matter, he would have to "just do it" and set priorities for which of the lawfully owed bills will get paid and which will not until there is more money in the Treasury to pay everything that the laws require to be paid. At some point down the road, the President could even decide to move other priorities higher than paying net interest. A President acting alone to decide which government bills to pay and which not to pay, operating without statutory authority, is anathema in a democracy based on law—clearly, something that is best avoided.

How Would Credit Markets React?

A key consideration for any course of action is how markets would react. For this it is important to recognize which measures of debt are relevant. As noted earlier, two measures of government debt are common to the debt limit discussion: debt that is sold in the credit markets (typically called "publicly held debt") and "gross debt" (also called the "public debt"), which includes publicly held debt plus debt the federal government has issued internally to record certain intergovernmental transfers such as transfers from the general fund to the Social Security trust fund.

Credit markets are concerned with the publicly held debt, its growth over time, and that net interest payments are made on time.[17] Publicly held debt stood at $9.018 trillion at the end of 2010.[18] While publicly held debt is the relevant measure of the debt for credit markets, the debt limit applies to the gross debt.

If the federal government were forced to operate indefinitely at the current debt limit, the early reaction in credit markets could be unfavorable. Credit markets value certainty and carefully evaluate and price uncertainty. Despite the recent run-up in federal debt and the tremendous difficulties the federal government faces due to promises made in major entitlement programs, U.S. government debt is still the global benchmark for safety. The uncertainty surrounding how the federal government would operate if it were unable to issue debt would likely rattle markets initially, leading to adverse movements in interest rates and the dollar exchange rate.

The news would not be all grim, however, as the passage of time probably would make clear. As noted, the Treasury Department would surely affirm that all interest payments on government debt would be made, thus reassuring bond holders. While spending cuts required to align total spending with revenues would be deep, triggering a huge political brouhaha, from the credit markets' perspective the overarching consideration would be that a government previously bent on issuing destabilizing amounts of debt would be running an enforced balanced budget. Once the novelty wore off—and how long this would take is uncertain—markets ultimately might see the forced austerity as beneficial, especially if they concluded that the result would be congressional action to put the government, after decades of endless spending and borrowing, on a sound financial footing.

Debt Limit Options

Congress faces a variety of options as the debt limit approaches. Fortunately, there is no immediate crisis; Congress has sufficient time to consider these options fully. The approaching debt limit is nevertheless clearly a forcing moment. Along with the upcoming vote on the appropriations continuing resolution to keep the government funded through the end of the fiscal year, the approaching debt limit offers a unique opportunity to bring spending and budget deficits under control for 2011 and beyond.

Preparing for the Possible. As a matter of simple prudence, Congress could consider certain legislative steps to prepare the government for the possibil-

17. For a discussion of why publicly held debt is the meaningful quantity, see Alex Brill, "Reform, Don't Raise, the Debt Limit," American Enterprise Institute, January 20, 2011, at *http://www.aei.org/article/103031*.
18. See Congressional Budget Office, "Federal Debt and Interest Costs," December 2010, at *http://www.cbo.gov/ftpdocs/119xx/doc11999/12-14-FederalDebt.pdf*.

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ity that it will exhaust its ability to borrow. For example, the Treasury Department already has certain flexibilities in managing cash flow and payments on a day-to-day basis. These flexibilities may need to be strengthened if government outlays are strictly limited by revenue inflows.

Congress could also consider legislation explicitly making the payment of net interest on public debt the first priority. This would further allay concerns in credit markets and end once and for all any notion that the United States government would default on its debt.

The approaching debt limit offers a unique opportunity to bring spending and budget deficits under control for 2011 and beyond.

While net interest would be the top priority, Congress could also consider legislation providing the Administration explicit guidance on prioritization of all other federal spending. For example, with troops in the field and America facing numerous national security threats, obligations incurred with respect to national security could receive top consideration among all other spending obligations. The payment of Social Security benefits is another area in which clear guidance could be forthcoming.

Option #1: Hold the line.

One option is to hold the debt limit in place, thereby forcing an immediate reduction in non-interest spending averaging about $125 billion each month. If this option is chosen, then the legislative guidance described above would be essential. Absent explicit guidance set by law, decisions regarding the prioritization of federal spending would be left to the President. Therefore, if Congress chooses to hold the line, it could also consider legislation providing even more detailed direction as to how the Administration should prioritize spending or provide specific cuts.

Option #2: Raise the limit and cut spending.

A second broad option is an increase in the debt limit that is accompanied by substantial, immediate spending reductions. A wide array of such immediate spending reductions is available.[19] It is important as well to consider that each of these spending cuts is a gift that keeps on giving: Reductions in spending today continue every year into the future unless reversed, and each such cut means less debt the federal government must issue and that much less net interest it must pay forevermore.

Option #3: Raise the limit and also enact tough budget reforms.

If the Congress opts to raise the debt limit, then in conjunction with deep, immediate spending cuts, it could also consider adopting specific, effective, and enforceable new budget rules to put the federal budget on a definite sustainable path within a defined short period. These reforms to guide the budget process would then drive more fundamental programmatic changes in the course of the current year and years to come.

For example, it is hardly surprising that federal spending continues to soar when the federal budget process lacks enforceable spending caps. Entitlement spending is on autopilot, and Congress, despite firm promises to the contrary, regularly waives what little discipline might be imposed under the various Pay-As-You-Go rules. Congress could adopt strict spending caps for total spending each year, backed by automatic sequestration triggers and other protections to prevent Members from waiving the rules.

If Higher, How High?

If Congress decides to raise the debt limit, it must also decide how high to set the new limit. Again, there are many possibilities.

Many Bites, Many Chances. One possibility is to enact a series of relatively small increases, each one of which would allow Congress an opportunity

19. For a starting point, see Brian M. Riedl, "How to Cut $343 Billion from the Federal Budget," Heritage Foundation *Backgrounder* No. 2483, October 28, 2010, at *http://www.heritage.org/research/reports/2010/10/how-to-cut-343-billion-from-the-federal-budget*.

to push through further spending reductions. The allure of multiple opportunities to cut spending is clear, but there is also the risk that the discomfort of raising the limit will diminish with repetition. Further, the legislative calendar already produces additional opportunities for spending reduction. For example, Congress must pass an appropriations continuing resolution for the balance of 2011, a budget resolution, and then the appropriations bills to fund the government for 2012.

Trust but Verify. Another option is to pass a "trust but verify" increase in the debt limit. For example, the increase could be sufficient to carry the federal government through to the end of the year. The debt limit should be increased *only* if accompanied by substantial spending reductions and firm expectations of more cuts to come, for example, through firm, enforceable spending caps putting the nation on a clear, quick path to a sound fiscal policy. If Congress fails to make good on these additional reductions, the threat of approaching the debt limit yet again would provide powerful leverage to force reforms and a built-in checkpoint for Congress to police itself.

This Congress, One Vote. Another option for achieving possibly even greater spending reductions is to make the coming debt limit debate in effect a once-per-Congress opportunity. That is, the increase in the debt limit, which might then be in excess of $2 trillion, would be made large enough to carry the federal government through this Congress and into early 2013. The prospect of such an increase, possibly eliminating the need for a repeat performance later in this Congress, might bring all parties to the table more willing to make much deeper immediate spending reductions and more stringent spending caps going forward. This would be a high-stakes option not only offering the possibility of the greatest changes in current and future spending, but also posing the greatest risk that a consensus would prove unattainable.

Charting a Sustainable Course

The federal budget deficit is unsustainable today because of out-of-control spending. Even as the economy strengthens and revenues recover, spending in years to come is slated to rise to even more unsustainable levels. Consequently, the federal government is about to run up against its statutorily imposed limit on issuing debt.

The silver lining in this otherwise dark cloud is that Congress has time to consider its options carefully. The matter is urgent but not immediate. If the federal government runs up against the debt limit, then the Treasury has tools to manage cash flow for a time before severe measures will be necessary to align the federal spending set in law with the receipts available to the Treasury. Treasury almost certainly will not default on its publicly issued debt. Nor will Congress imperil the standing of U.S. government debt in the credit markets, risking America's "full faith and credit," as the President's chief economic adviser has said.

If Congress ultimately inclines toward raising the debt limit, then it could, in the same legislation, impose immediate, substantial spending reductions along with strong new rules such as hard spending caps to require continued, sharp spending reduction in future years. The outcome should reflect a clear, quick path to a sound fiscal policy. Congress should also consider carefully both the size of any increase in the debt limit in light of the other opportunities it will have over the course of the year to reduce spending and the importance of having yet another forcing opportunity if further spending reductions are not forthcoming. The responsibility for driving down spending and borrowing rests—under our Constitution—squarely with the Congress and the President of the United States.

—J. D. Foster, Ph.D., is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

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